Monthly Report of Prospects for Japan's Economy

July 2025

Macro Economic Research Center

Economics Department

The Japan Research Institute, Limited

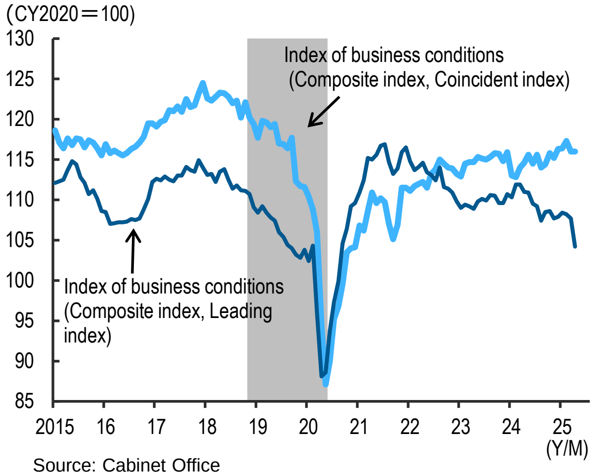
https://www.jri.co.jp/english/periodical/

This report is the revised English version of the June 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

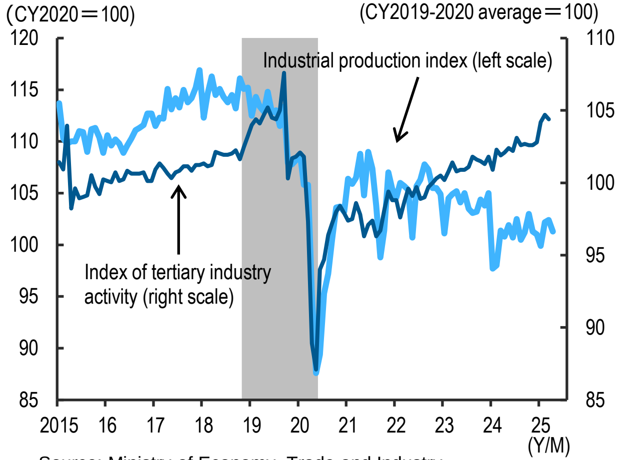
The coincident index of business conditions is weak, and the leading index has deteriorated significantly.



Source: Cabinet Office

Figure 1-2 The Corporate Sector

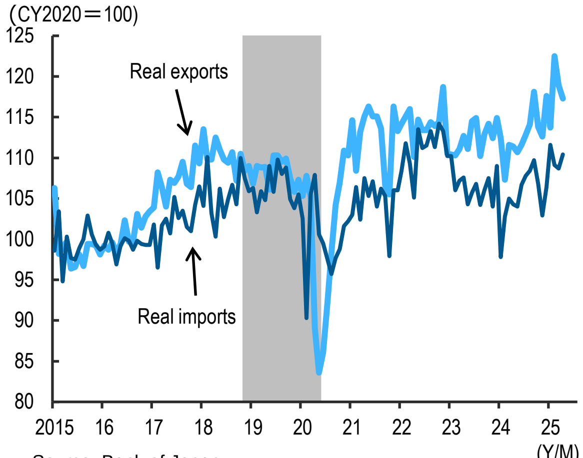
Industrial production is weak.
Economic activity in the service sector is recovering.



Source: Ministry of Economy, Trade and Industry

Figure 1-3 Overseas Demand

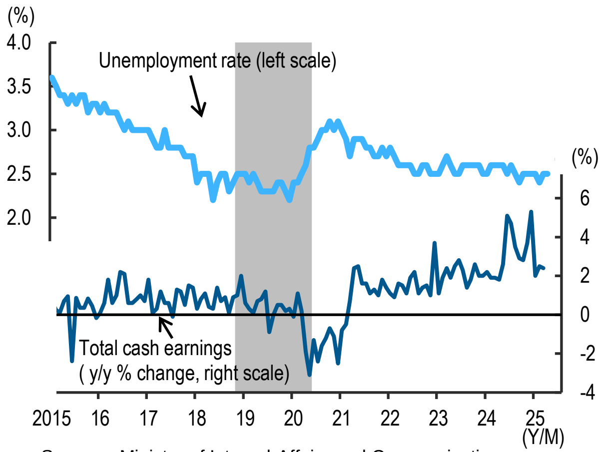
The rise in exports has paused.
Imports are increasing.



Source: Bank of Japan

Figure 1-4 Employment and Income

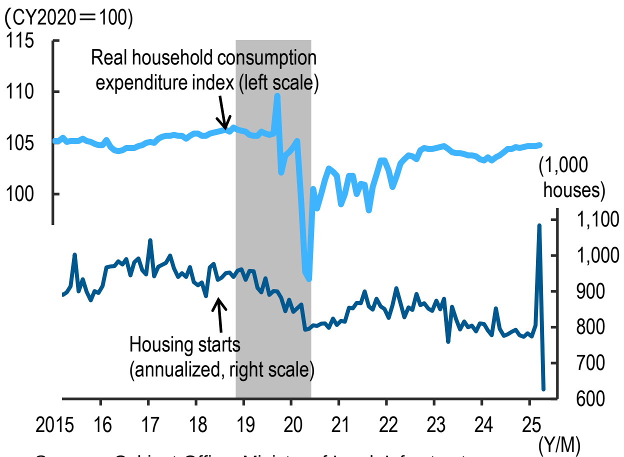
The unemployment rate is low, hovering around 2.5%.
Nominal wage growth is solid, averaging at just above 2%.



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

Figure 1-5 The Household Sector

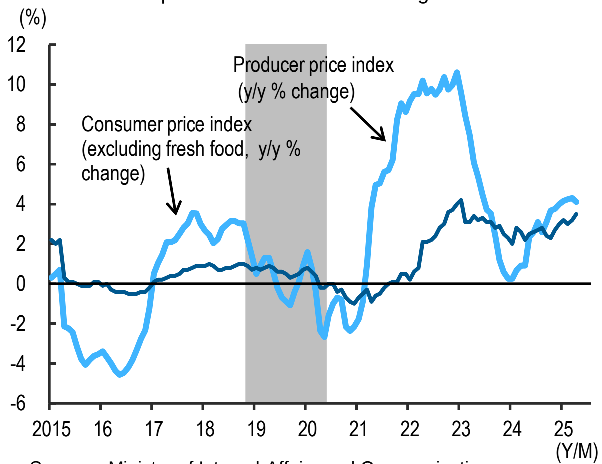
Consumption is slowly picking up.
Housing starts have fallen back dramatically after a surge.



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

Figure 1-6 Prices

Producer price inflation is fairly high.
Consumer price inflation is accelerating.



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

∗ The shaded area represents the period during which the Japanese economy was in recession.

Real GDP for January-March 2025 has been revised upward

◆ Real GDP has been revised upward

In the second QE (quarterly estimate) for January-March 2025, real GDP growth was put at -0.2% quarter over quarter (QoQ) on an annualized basis and -0.0% QoQ, an upward revision from the -0.7% in the first QE. Capital investment was revised slightly downward, while inventory investment and personal consumption saw upward revisions.

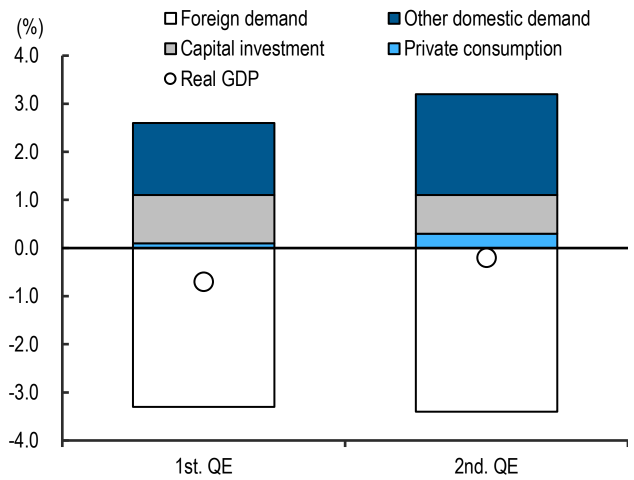
◆ Production in the manufacturing sector is fluctuating

In April, the Industrial Production Index dropped by 0.9% month over month (MoM). Amid growing uncertainty over U.S. tariff policy, output declined in sectors such as production machinery and transportation machinery.
According to near-term production plans, output is expected to begin increasing rapidly in areas such as production machinery, electrical machinery, and information and communications equipment. However, production plans tend to be set higher than actual output turns out to be. As tariffs hit Japanese exports, production will likely be lower than the plans indicate. This is particularly true in machinery-related sectors, many of which are export-oriented.

◆ Housing starts increased sharply before amendments to the law took effect but have since fallen back dramatically

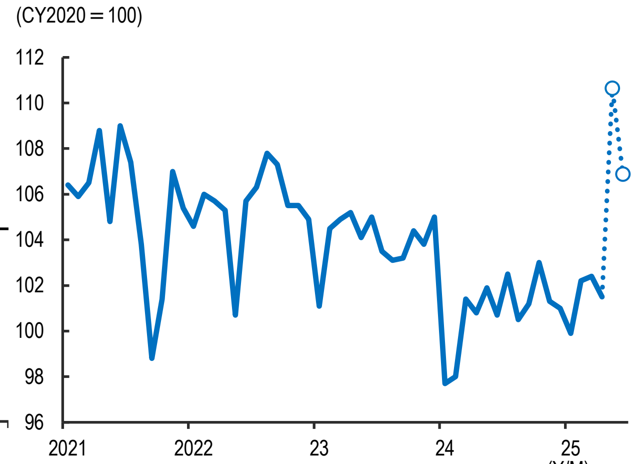
Housing starts have been volatile. After surging to 1.08 million units (seasonally adjusted annualized rate) in March, the number of housing starts plunged to 0.62 million units in April, exhibiting a massive change between the end of the previous fiscal year and the start of the new one. The amendments to the law included the mandatory application of energy-saving standards to buildings for which construction starts in or after April, causing a rush in demand before the new rules took effect. Housing starts are expected to remain subdued for now, given the rush demand will continue to peter out and the presence of structural dampeners such as population decline.

Figure 2-1 Real GDP Growth Rate for Jan-Mar 2025 <YoY annual growth rate>



Source: Japan Research Institute, Ltd. based on data from the Cabinet Office

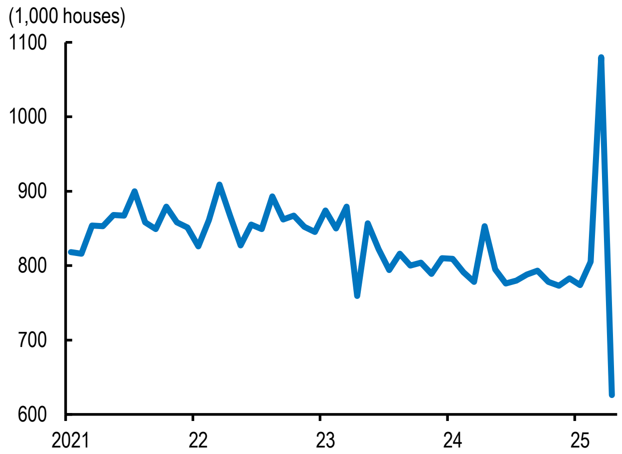
Figure 2-2 Industrial Production Index <seasonally adjusted>



Source: Ministry of Economy, Trade and Industry

Note: The dotted line is an extension based on the manufacturing production forecast index for May and June.

Figure 2-3 Housing Starts <annualized, seasonally adjusted>



Source: Ministry of Land, Infrastructure, Transport and Tourism

Corporate earnings have been deteriorating since April

◆ Ordinary profit fell in January-March

Ordinary profit (all industries) for the January-March 2025 quarter dropped 2.6% QoQ. Although net sales rose for the fourth straight quarter as companies passed on higher costs to their customers, yen appreciation reduced the yen value of many companies' dividend incomes from abroad (booked as non-operating income), manufacturing firms in particular. This pushed down ordinary profits. In addition, higher personnel expenses due to wage increases weighed on earnings.

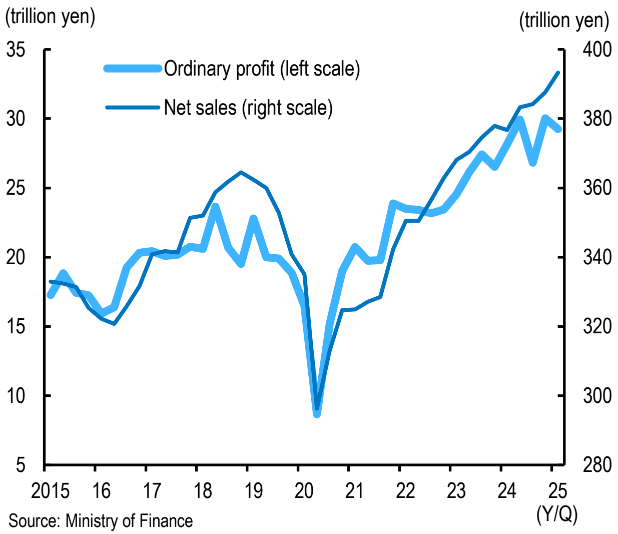
Capital investment (including software investment) was up 1.6% QoQ, climbing for the fourth quarter in succession. By capital investment type, software investment remained strong, and other investment continued to rise.

◆ Higher U.S. tariffs will hit the corporate sector

Corporate earnings are expected to deteriorate going forward. Due to the U.S. tariff hikes, earnings will decline, particularly in manufacturing. In their earnings announcements for the year to March 2025, some major companies, chiefly ones in the automobile and steel industries, stated that they expect to see a significant decline in profits in the year to March 2026. Meanwhile, others refrained from providing guidance at all due to increased uncertainty.

As a result of this deterioration in corporate earnings and the heightened uncertainty, machinery investment is likely to weaken in the near term. However, software investment for labor-saving is expected to support capital investment overall. Software investment aimed at addressing medium- to long-term challenges tends not to be greatly affected by economic fluctuations.

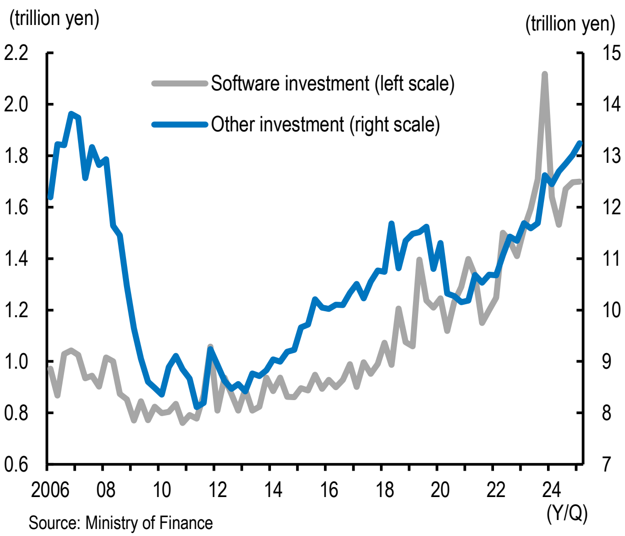
Figure 3-1 Ordinary Profit and Net Sales <seasonally adjusted>



Source: Ministry of Finance

Note: Firms of all sizes and in all industries apart from financial and insurance are included.

Figure 3-2 Capital Investment by Corporate Enterprises <seasonally adjusted>



Source: Ministry of Finance

Note: Firms of all sizes and in all industries apart from financial and insurance are included.

Figure 3-3 Number of Foreign Visitors to Japan and Consumption by Inbound Tourists

Industry	Company	Prospect	Details (tariff impact forecast, etc.)
Auto giant	①	Profit decrease	･Sales slightly up, but profit down -35%
	②		･Sales down, profit down -70%
	③		･Sales up, but profit down -2.4%
	④	To be determined	･Tariff impact is ¥450 billion, sales down
	⑤		･Tariff impact is ¥360 billion
	⑥		･Tariff impact is ¥10 billion in April alone
Steel giant	⑦	Profit decrease	･All are expected to see a 10% decrease or more ･Indirect impact is said to be larger for transportation machinery than for direct exports
	⑧		
	⑨		

Source: Japan Research Institute, Ltd based on data from various company data and media reports, etc.

Note: Excerpts from each company's final profit plan for FY2026. All percentages in the table are growth rates from FY2025.

The labor market is tight, and personal consumption remains steady

◆ Labor-market tightness is approaching its limit

The unemployment rate is low, hovering around 2.5%. Although labor force participation has risen, due mainly to increased participation among women and the elderly, most of the additional labor has already been absorbed, particularly in non-manufacturing sectors, where workforces are growing. Population decline is also keeping unemployment down structurally.

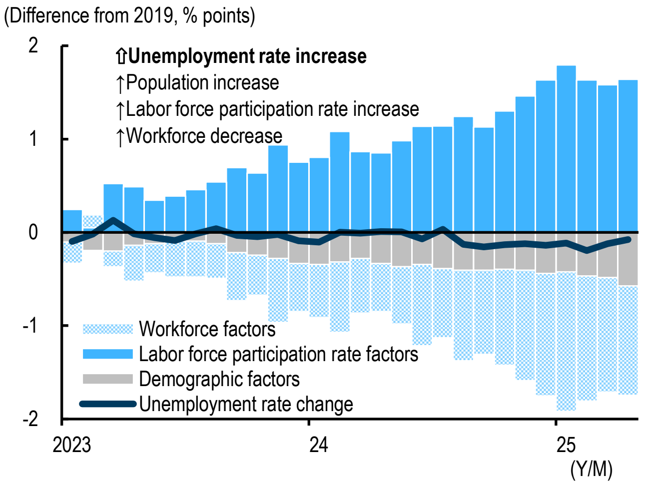
The labor market is thus expected to remain tight in the near term. On the demand side, the increases in U.S. tariffs will weigh on production activities and corporate earnings, and likely weaken labor demand in the manufacturing sector. Still, non-manufacturing sectors, buoyed by robust domestic demand, will support overall labor demand. Meanwhile, on the supply side, the share of people not in the labor force who wish to work is declining, so there is limited room for additional expansion in the supply of labor.

◆ Services consumption is supporting consumption

Personal consumption is picking up. By type, goods consumption has been weak recently. Consumption of durable goods such as home appliances and automobiles has slumped, and consumption of non-durable goods has also declined due to factors such as soaring food prices. However, services consumption remains on the recovery track, particular in areas such as dining out. Higher prices of food products could be causing a shift in consumption from eating at home to dining out.

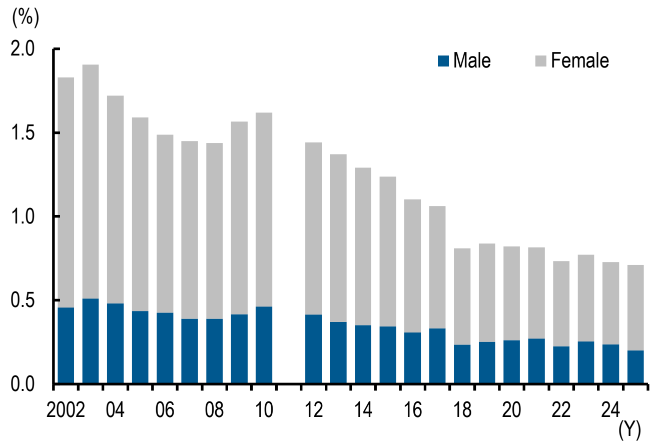
Personal consumption is also expected to remain resilient going forward. Inflation will slow due to falling energy prices and a lull in soaring food prices, while nominal wage growth should stay solid as the wage increases agreed at this year's shunto (spring wage negotiations) go into effect. As a result, the trend of rising real wages will become clear from the summer. This is expected to support consumption.

Figure 4-1 Changes in the Unemployment Rate Broken Down by Factor <seasonally adjusted>



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

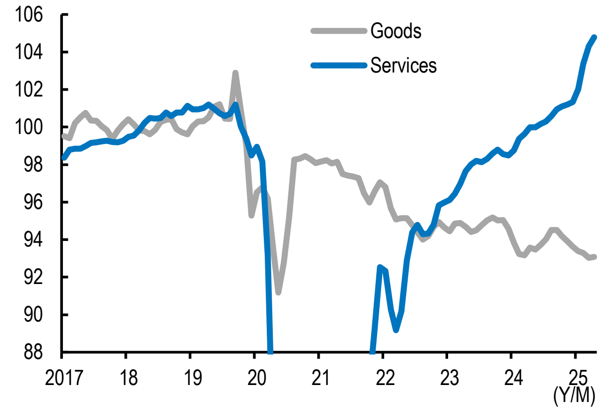
Figure 4-2 People not in the Labor Force Wishing to Work



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

Note: This represents the number of people not in the labor force who wish to work, as a percentage of the population aged 15 and over. 2025 figures are for the January-March period; 2011 figures are not shown due to the Great East Japan Earthquake.

Figure 4-3 Consumption Activity Index <seasonally adjusted>



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

Note: The backward three-month moving average was used.

Inflation is slowing

◆ The rise in food prices is beginning to level off

In April, core inflation (all items, less fresh food) accelerated from the previous month to hit 3.5%. The government has essentially eliminated high school tuition fees, which pushed down service prices, but energy prices rose as the government cut subsidies for electricity and gas bills. In addition, rising food prices continued to push up inflation.

Price growth is expected to slow until early next year and then remain around 2%. Impacts from unusual weather have run their course, and wholesale prices of fresh vegetables remain below the levels seen in typical years. The ripple effect from this is expected to bring a pause to the rapid rise of food prices. In addition, energy prices should fall due to a worldwide drop in energy demand and the effect of government energy subsidies. The government plans to resume subsidies for electricity and gas bills in the summer, and will continue to provide subsidies for gasoline, though in a new, 10-yen-per-liter fixed format. However, as wage increases are passed on to selling prices, higher service prices are expected to support prices overall.

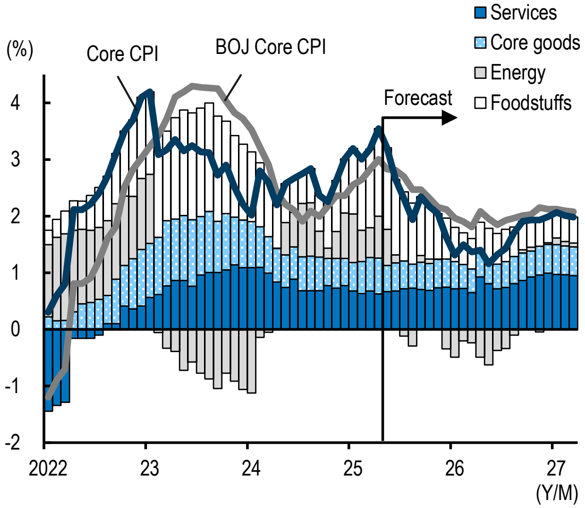
◆ The Bank of Japan (BOJ) will keep its policy rate unchanged

At its monetary policy meeting at the beginning of May, the Bank of Japan (BOJ) decided to keep its policy rate unchanged.

Long-term interest rates have risen. As a background factor, fears of an economic slowdown have eased in response to progress in tariff negotiations between the U.S. and China, renewing expectations of an early BOJ interest rate hike.

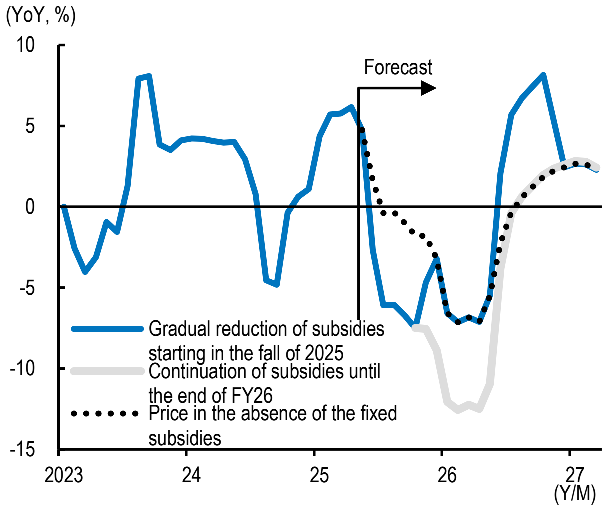
Amid lingering uncertainty surrounding U.S. tariff policy, the BOJ is expected to leave its policy rate unchanged in the near term. The next rate hike is expected to be in March 2026. For the time being, long-term interest rates look likely to remain more or less flat, after which they should rise gradually, reflecting heightened anticipation of a rate hike by the BOJ.

Figure 5-1 Consumer Price Index <YoY>



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

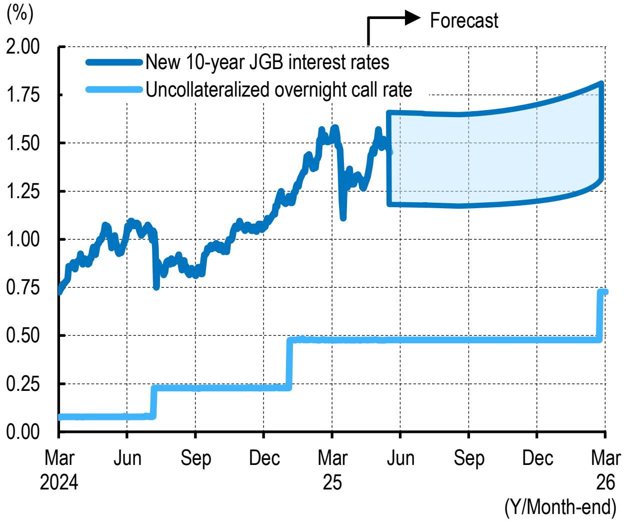
Figure 5-2 Gasoline Price Forecast Factoring in Fixed Subsidies



Source: Japan Research Institute, Ltd. based on data from the Ministry of Economy, Trade and Industry

Note: Calculated based on our crude oil price forecast. Our price forecasts are based on a scenario assuming a phased subsidy reduction beginning in fall 2025.

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



Source: NEEDS-FinancialQUEST

Topic ①: Trump tariffs will weigh on manufacturing wages

◆ U.S. tariffs will lead to lower exports to the U.S.

When their tariff burden increases due to the U.S. tariff hikes, Japanese companies will respond in various ways, such as 1) passing the burden on to customers in the form of higher prices, or 2) trying to absorb it internally by cutting costs or negotiating price reductions with suppliers.

However, in either case, a drop in export value is inevitable. In case 1), higher prices in the U.S. will reduce export volume, while in case 2), lower pre-tariff prices of exports will significantly reduce exports in monetary terms.

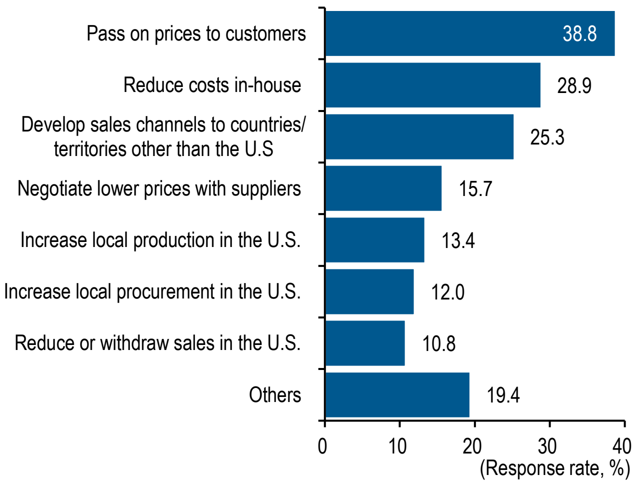
Taking into account these different approaches to passing on tariff costs, if the current 10% reciprocal tariffs and 25% automobile tariffs stay in place, it is estimated that the value of Japan's exports to the U.S. will decrease by 16-21% from the baseline level. Furthermore, if the additional reciprocal tariffs (which would add another 14%) are imposed, the drop in export value would be even larger, falling 20-30% from the baseline level.

◆ The pace of wage increases could also slow

If, as a result of the decreased exports, earnings in Japan's manufacturing sector fall, there is a danger that the momentum for raising wages will wane. According to a survey conducted by Tokyo Shoko Research in April 2025, immediately after the announcement of the reciprocal tariffs, 5% of all companies said they were planning to hold off on wage increases in the next fiscal year.

It is estimated that if the current tariffs remain in place, manufacturing wages will increase by 2.4-2.6% year over year (YoY), a significant deceleration from the 3.3% rise recorded at the end of FY2024. And if the additional reciprocal tariffs are also implemented, it is estimated that the rate of wage increase would be much lower, at 2.0-2.4%.

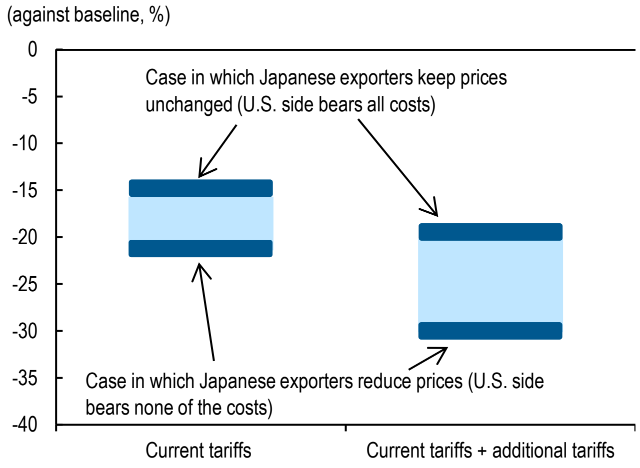
Figure 6-1 Measures to Address Additional Tariffs (multiple responses allowed)



Source: Japan Research Institute, Ltd. based on data from the Japan External Trade Organization

Note: Survey period: April 11-16, 2025; number of respondents: 7,589.

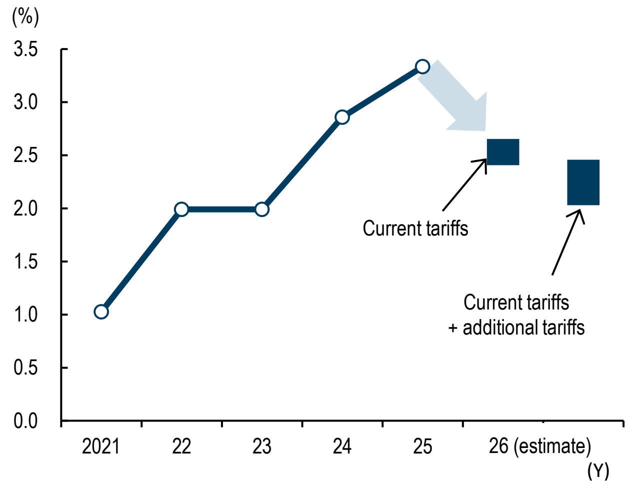
Figure 6-2 Downward Swing in Exports to the U.S.



Source: Japan Research Institute, Ltd. based on data from Bank of Japan, U.S. Department of Commerce, etc.

Note: For the method of estimation, see Fujimoto and Nishioka [2025], "Trump Tariffs Hinder Wage Hike Momentum," Japan Research Institute, Research Focus, No. 2025-015.

Figure 6-3 Wages in the Manufacturing Sector <YoY>



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

Note: For the method of estimation, see Fujimoto and Nishioka [2025].

Topic②: Cutting the consumption tax would boost consumption but also create a mountain of issues

◆ A consumption tax reduction would stimulate consumption to a certain extent

Ahead of the upper-house election in July, various parties are calling for a consumption tax cut. A reduction in the consumption tax would impact personal consumption through three basic channels: 1) the income effect (where higher lifetime household income leads to increased consumption), 2) the intertemporal substitution effect (where people consume more when the tax rate is low), and 3) the effect of purchase deferrals (or rush buying) and the subsequent rebound. If the effect of purchase deferrals (or rush buying) is assumed to be on the same scale as the subsequent rebound, the consumption stimulus effect would be the sum of the income effect and the substitution effect.

Estimates indicate that cutting the consumption tax would stimulate consumption to a certain extent. Notably, if the tax reduction were to be permanent, real consumption would increase by an estimated 1.5-4.4% over the medium to long term, though where in this range the actual increase would lie would depend on the income effect. However, if consumers expect the tax to be hiked back up in the future, the income effect would be small, so the estimated increase needs to be interpreted with a margin of uncertainty.

◆ A consumption tax reduction would lead to huge fiscal risks

While it would have the effect of stimulating consumption, a consumption tax cut would also pose significant fiscal risks. Consumption tax is an important financial resource for fiscal soundness and sustainability because 1) fluctuations in the tax revenue in response to changes in economic conditions are small, and 2) the tax revenues tend not to decrease even as the population ages because the tax burden is also borne by non-employed people, including the elderly. Even if the tax cut is initially claimed to be temporary, political considerations would make it difficult to put the tax rate up again later, so worries about Japan's fiscal health would be likely to grow. If fiscal deterioration causes long-term interest rates to rise further, the government could be forced to raise taxes or cut spending.

A uniform consumption tax reduction covering all goods could also make the economy more volatile. Although purchase deferrals and rush buying would have little effect on demand for fresh food, which is difficult to stockpile, demand for durable goods, where there is room for flexibility in the timing of purchases, would be significantly impacted. The level of consumption, particularly of durable goods, would change dramatically before and after any tax cut.

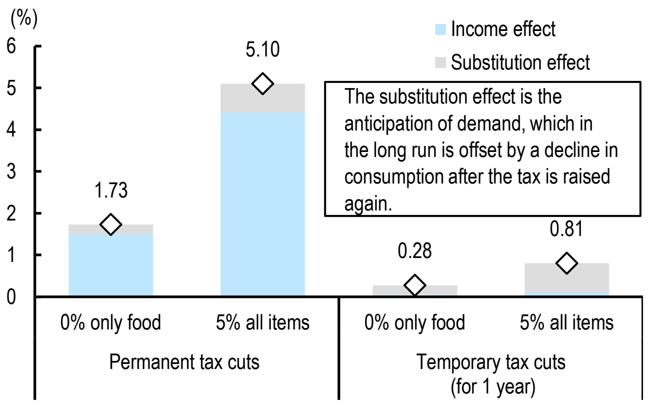
Figure 7-1 Stance of each Political Party on Consumption Tax Cuts

	Only food	All items
Permanent tax cuts	・Conservative Party of Japan ・Social Democratic Party: To 0% permanently ・(Komeito): Temporary tax cuts	・Reiwa Shinsengumi: At least 5% ・Communist Party: 5% ・Sansei Party *All of them plan to abolish consumption tax in the future/phase-out.
Temporary tax cuts	・Constitutional Democratic Party of Japan: 0% for 1 year ・Japan Innovation Party: 0% for 2 years	・Democratic Party For the People: 5% uniformly for a limited time

*The Liberal Democratic Party is critical of tax cuts.

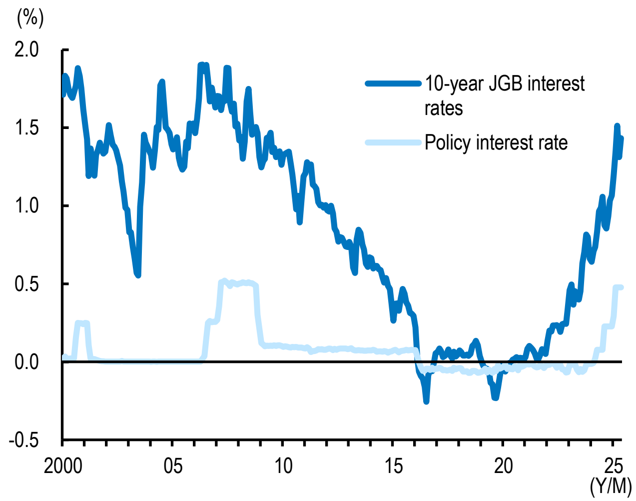
Source: Japan Research Institute, Ltd based on data from each party and various media reports.
Note: 10 political parties that won seats in the 2024 House of Representatives election.

Figure 7-2 Estimated Effects of Consumption Tax Cuts in Stimulating Consumption



Source: Japan Research Institute, Ltd
Note: Consumer prices are assumed to fluctuate only by the amount of the tax rate change. The elasticity of substitution between different points in time is assumed to be 0.15, illustrating the consumption boosting effect during the tax cut period. The effects of restrained buying/rush to purchase and overreaction are not taken into account.

Figure 7-3 Japan's Main Interest Rates



Source: Japan Research Institute, Ltd based on data from NEEDS

U.S. tariffs will create downward economic pressure

◆ Economic growth will slow

Looking ahead, Japan's economy is expected to slow down. 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 remain resilient going forward, though the pace of increase is expected to slow. Against a backdrop of worsening business performance, bonuses in the second half of this fiscal year will rise by a smaller margin. Basic salaries will continue to increase as a reflection of structural labor shortages, particularly in non-manufacturing sectors, but the pace of increase is expected to slow.

Regarding capital investment, while software investment looks set to keep rising, there is a high degree of uncertainty surrounding U.S. tariffs, so machinery investment in the manufacturing industry is weak.

◆ A 0.2% growth rate is expected in FY2025

Real GDP growth is projected to be 0.2% 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, tit-for-tat imposition of retaliatory tariffs by the U.S., China, and the EU would also apply downward pressure.

Figure 8 Projections for GDP Growth and Main Indicators of Japan (as of June 9, 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	-0.2	-0.3	0.3	0.7	0.7	0.8	0.8	0.8	0.9	0.8	0.2	0.7
Private Consumption Expenditure	0.6	0.2	0.4	0.7	0.8	0.5	0.5	0.5	0.5	0.8	0.6	0.5
Housing Investment	5.6	-6.2	-0.1	0.1	-0.0	0.0	0.0	-0.1	0.0	-1.0	-0.5	-0.0
Business Fixed Investment	4.4	-4.1	0.3	0.2	0.3	0.6	0.9	0.9	1.0	2.4	0.1	0.6
Private Inventories (percentage points contribution)	(2.1)	(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	2.2	1.1	1.0	1.1	2.0	1.6	1.5	1.9	1.3	0.7	1.5
Public Investment	-2.5	3.0	1.6	1.4	1.0	1.3	1.7	1.8	1.5	1.3	0.3	1.4
Net Exports (percentage points contribution)	(-3.5)	(-0.2)	(-0.4)	(-0.1)	(-0.1)	(-0.1)	(-0.0)	(-0.0)	(-0.0)	(-0.4)	(-0.5)	(-0.1)
Exports of Goods and Services	-2.2	-4.8	-1.0	0.5	0.5	0.7	0.9	1.1	1.2	1.7	-0.6	0.7
Imports of Goods and Services	12.7	-3.6	0.9	1.0	1.0	1.1	1.2	1.2	1.3	3.5	1.5	1.1
	(% changes from the same quarter of the previous year)									(% changes from the previous fiscal year)		
Nominal GDP	5.1	4.7	3.6	3.0	2.9	2.5	3.0	3.2	3.3	3.7	3.5	3.0
GDP deflator	3.3	4.1	3.1	3.2	2.7	2.0	2.3	2.4	2.4	2.9	3.3	2.3
Consumer Price Index (excluding fresh food)	3.1	3.1	2.2	1.9	1.4	1.3	1.7	1.9	2.0	2.7	2.2	1.7
Unemployment Rate (%)	2.5	2.5	2.5	2.4	2.4	2.4	2.4	2.4	2.4	2.5	2.4	2.4
Exchange Rates (JY/US$)	153	144	143	141	138	136	135	135	135	153	142	135
Import Price of Crude Oil (US$/barrel)	79	73	63	61	62	65	68	68	69	83	65	67

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.