10 March 2025 (No. of pages:16)

Japanese report: 26 Feb 2025

Japan’s Economy: Monthly Outlook (Feb 2025)

Economic Outlook Revised: Recovery expected, but wary of “Trump 2.0” and other factors

Economic Research Dept.
Keiji Kanda
Shotaro Kugo
Munehisa Tamura
Akane Yamaguchi
Kazuma Kishikawa
Kanako Nakamura

Summary

- In light of the announcement of the Oct-Dec 2024 GDP 1st preliminary results, we have revised our economic outlook. We now see growth in Japan’s real GDP according to our main scenario at +0.7% in FY2024, and +1.3% in FY2025, and +1.1% in FY2026. (On a calendar year basis we expect +1.5% in 2025 and +1.1% in 2026).

- We expect the growth trend in real wages to become clearly established with the continuation of wage hikes as a result of the spring labor negotiations. Growth of around +1% y/y is expected to be maintained in FY2026. We also expect the growth rate in CPI to be at around 2% due to the cycle of wage increases and price pass-through. Japan’s economy can expect to find underlying support and growth factors including improvement in the household income environment, economic stimulus measures by the government, growth in inbound demand, the high level of household savings, and other factors. However, vigilance is necessary regarding changes in the external environment, including the policies of the US Trump administration (“Trump 2.0”), and major appreciation of the yen.

- We assume that the Bank of Japan (BOJ) will raise the short-term interest rate to 0.75% in the Jul-Sep 2025 period (July in monthly terms), followed by additional rate hikes at a pace of once every six months, 0.25%pt at a time. Short-term interest rates are expected to reach 1.50% by the end of the forecast period. Real interest rates will remain in negative territory throughout the forecast period, maintaining an accommodative monetary environment for the time being.

1. Moderate Recovery Expected, but Wary of "Trump 2.0" and Other Factors

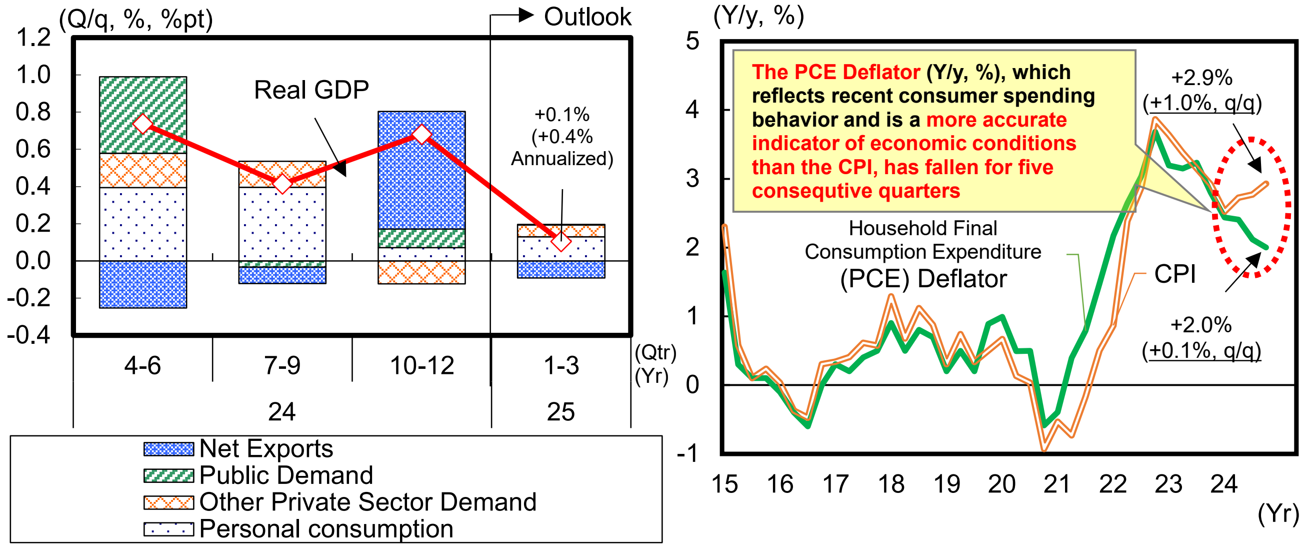
Real GDP achieves third consecutive quarter of positive growth in Oct-Dec period of 2024

The real GDP growth rate for Oct-Dec 2024 (1st preliminary est) was up by +2.8% q/q annualized (+0.7% q/q), the third consecutive quarter of positive growth [1]. Growth was seen in a broad range of components including exports and capex, however, the decrease in imports significantly boosted the GDP growth rate, and this point needs to be taken into account.

Looking at performance by demand components in the Oct-Dec 2024 period (Chart 1, left), in the area of private sector demand, while private consumption, capital expenditure and housing investment grew, contribution of private sector inventories to GDP growth fell into negative territory. As for public sector demand, government consumption grew, but public investment declined. Meanwhile, in the area of overseas demand, exports grew while imports declined. Hence net exports registered positive growth for the first time in five quarters.

Of these, personal consumption remained firm at +0.1% q/q in the Oct-Dec period, although many had expected a decline due to the high growth rate of +0.7% for two consecutive quarters since the Apr-Jun period of 2024 and soaring prices centering on food products. One of the reasons for this is believed to be that while consumers refrained from purchasing some food and other items whose prices were high, they became more active in purchasing items whose prices were stable, thereby easing the impact of high prices on private consumption.

Real GDP Growth Rate Results & Outlook (Left); CPI & Household Final Consumption Expenditure Deflator (Right) **Chart 1**



Source: Cabinet Office, Ministry of Internal Affairs and Communications; compiled by DIR.
Notes: Figures in the left side chart are seasonally adjusted. The right side chart shows a y/y comparison of underlying figures. Only the q/q comparison in parentheses is calculated from seasonally adjusted figures.

The Oct-Dec period consumer price index (CPI) recorded an increased growth rate on a y/y basis for the third consecutive quarter at +1.0% q/q. On the other hand, the household final consumption expenditure (PCE) deflator in the GDP statistics remained at +0.1% (Chart 1, right). Since the CPI is fixed at the consumption basket for the base year (currently 2020), for example, when the price of a certain product rises, actions such as reducing purchases of that product while increasing purchases of products with stable prices are not reflected in the CPI. The PCE deflator, which reflects this, is more representative of the real situation than the CPI and is a price index that is also emphasized by the Federal Reserve

[1] See the DIR report by Keiji Kanda and Munehisa Tamura dated 18 February 2025, *Oct-Dec 2024 1st Preliminary GDP Estimate.*

Board (FRB). The price growth faced by households has not increased as much as the CPI, and as a result, real consumption expenditures for the Oct-Dec period predicted before the release of the CPI and other data are thought to have been weaker than the actual figures.

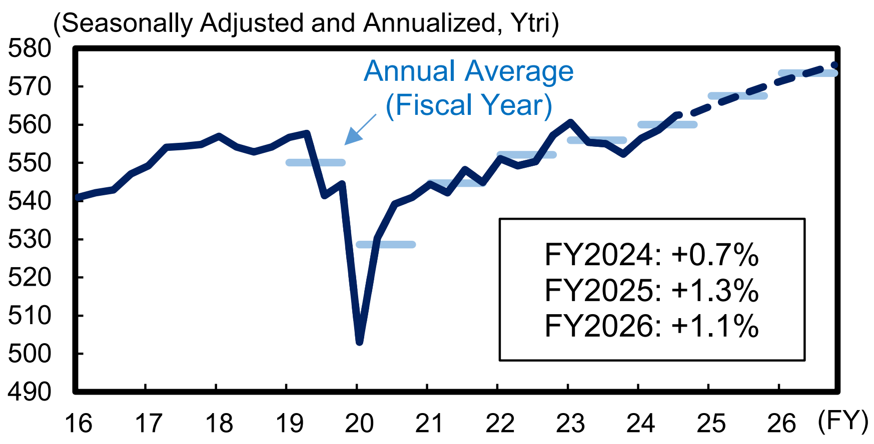
Real employee compensation increased for the fifth consecutive quarter at +1.5% q/q, its highest level since the Jan-Mar period of 2021. According to the Ministry of Internal Affairs and Communications' Labour Force Survey, the number of employees increased by +0.6%, and real employee compensation per capita (≒real wages) divided by the number of employees grew by +0.9%. The latter statistic has been increasing in positive growth rate on a y/y basis for three consecutive quarters, clearly showing a growth trend in real wages more so than in the Ministry of Health, Labour and Welfare's Monthly Labour Survey (Chart 4, right).

We expect Japan's 2025 Jan-Mar period real GDP growth rate to increase by +0.4% q/q annualized (+0.1% q/q). Although the growth rate is modest due partly to imports having shifted into growth, a fourth consecutive quarter of positive growth is expected (Chart 1, left).

Japan's real GDP expected to grow by around 1% through FY2026

Chart 2 illustrates our main scenario for the trend in real GDP, based on our outlook for overseas economies. Our latest outlook for overseas economies dated February 26 is provided by our in-house expert on the overseas economy. For details see the economic outlooks for the various countries included.

Outlook for Japan's Real GDP (Left) and Assumptions Regarding Overseas Economies (Right) Chart 2



US, Eurozone & China
Real GDP Growth Rate

US	2024: 2025: 2026:	+2.8% +2.3% +2.1%
Eurozone	2024: 2025: 2026:	+0.7% +1.2% +1.4%
China	2024: 2025: 2026:	+5.0% +4.5% +4.2%

Source: Produced by DIR based on data from the Cabinet Office and statistics by various countries.
Note: The dashed line in the chart represents predicted values as estimated by DIR. Outlooks for the US, Eurozone and China are based on predictions by DIR's in-house expert.

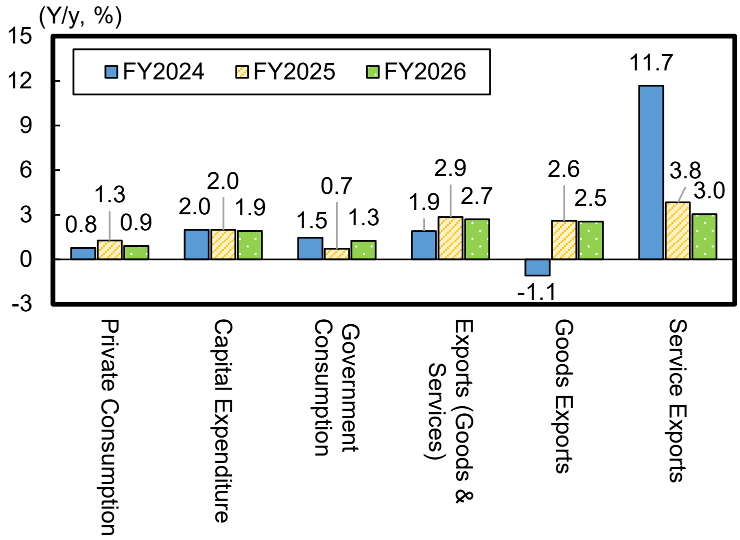
Based on the above overseas economic outlook, Japan's real GDP growth rate according to our main scenario is expected to be +0.7% in FY2024, and +1.3% in FY2025, and +1.1% in FY2026 (+1.5% in 2025 and +1.1% in 2026 on a calendar year basis).

The outlook for the FY2024 growth rate was revised upwards by 0.2%pt from our report of December 9, 2024 (*Japan's Economic Outlook No. 223 Update* (Japanese only), hereafter "our previous outlook"). This was due to the downturn in imports during the Oct-Dec 2024 period, and the retroactive revision of past performance in public investment and other factors. Meanwhile, the outlook for FY2025 was revised downward by 0.1%pt in comparison to our previous outlook. This is due to the downward revision of the 2025 Jan-Mar period growth rate after inclusion of the recovery in imports amongst other factors, which caused a decline in carryover (real GDP growth rate that can be achieved with zero q/q growth in each quarter) to +0.5%.

In this report we also provide an outlook for FY2026 for the first time. We expect the real GDP growth rate on a quarterly basis to achieve a moderate recovery of around +1% q/q annualized.

Major demand components are expected to perform as illustrated in Chart 3. Of these, private consumption is expected to continue to achieve moderate growth, backed by an improving income environment due to major wage hikes, as well as the high level of household savings, which are at a high level.

Outlook for Major Demand Components **Chart 3**



Source: Cabinet office; compiled by DIR.

Due to the worsening labor shortage and other factors, the 2025 spring labor negotiations are likely to result in a high wage increase rate, similar to the previous year. We expect the rate of wage increase in the 2025 spring labor negotiations including regular salary increases to be at around +5.0%[2] (weighted average, data compiled by the Japanese Trade Union Confederation (RENGO)). Rate of increase in base-pay is expected to be around +3.5%. Looking at a y/y comparison of scheduled cash earnings of general workers based on the results of a regression of the base-pay rate over the past forty years (1985-2024), scheduled cash earnings of general workers could increase to +4.1% y/y in FY2025 (Chart 4, left). However, FY2023 and FY2024 (est. performance) fall below the regression line, and if the relationship between the two years is automatically extended, FY2025 would be only at +2.7%. We included accelerated wage hikes at small and medium-sized enterprises in our estimate and expect an increase of around +3.0% in the scheduled cash earnings of general workers in FY2025. We expect the same level of growth in FY2026 due to continued aggressive wage hikes and other factors.

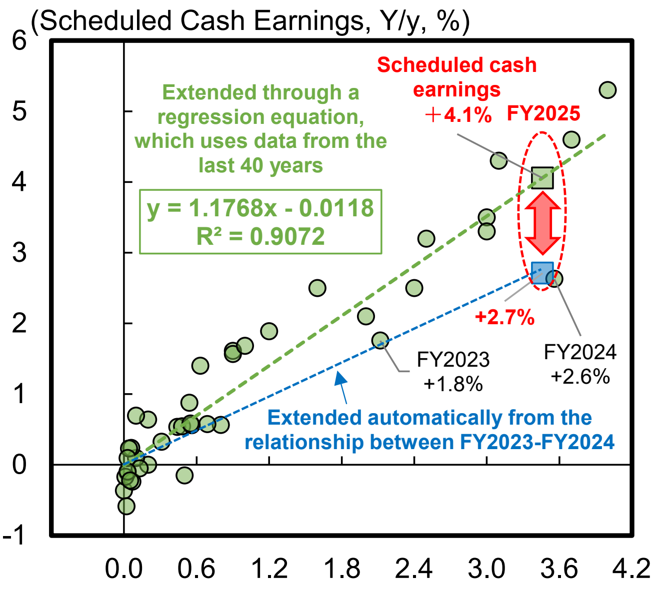
From a macro perspective, wages are expected to remain firm. Real employee compensation per capita, which is considered to express the actual situation[3] better than the real wage index of the Ministry of Health, Labour and Welfare's Monthly Labour Survey, rose into positive territory on a y/y basis for the

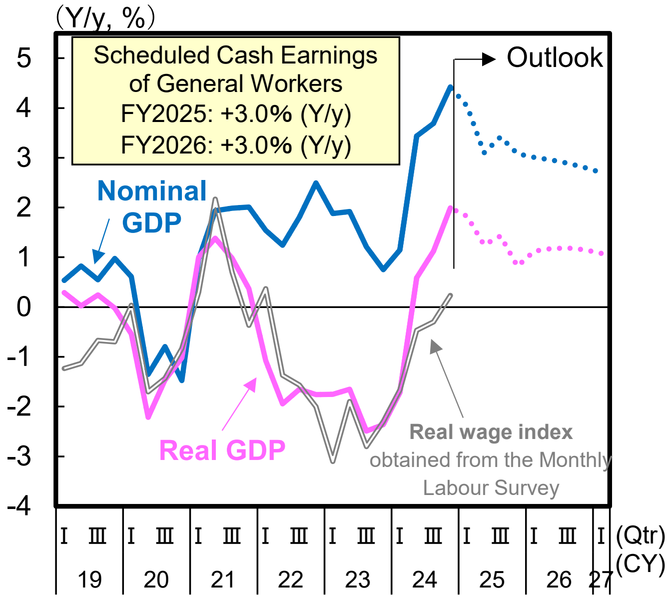
[2] Based on an estimation formula using corporate performance, labor supply and demand, and the rate of price increases as explanatory variables, the wage increase rate for the spring labor negotiations in 2025 is estimated to be around 4.2% on a RENGO aggregate basis, which may be a decrease from the previous year (5.1%). On the other hand, both labor and management have recently shown a positive attitude toward wage increases against the backdrop of intensifying competition among companies for human resources and high prices, especially for foods. In addition, price pass-through is more likely to progress further, and given the possibility that more small and medium-sized enterprises will switch from bonus hikes to base-pay increases in order to secure labor, this forecast assumes a wage increase rate around the same as the previous year.

[3] For more detail on the differences between employee compensation per capita in the GDP statistics (Cabinet Office) and the real wage index of the Ministry of Health, Labour and Welfare's Monthly Labour Survey, see "How Will 2025 Real Wages Turn Out?" by Keiji Kanda (the DIR column, January 27, 2025) (Japanese only).

first time in ten quarters in the Apr-Jun period of 2024, with growth accelerating to +2.0% in the Oct-Dec period (Chart 4, right). While phases of decline in the growth rate are likely to occur as price increases reaccelerate, real employee compensation per capita will likely maintain growth of around +1% through FY2026, around the same as growth in labor productivity up to now.

Rate of Base-Pay Increase and Growth Rate in Scheduled Cash Earnings of General Workers (Left), Outlook for Employee Compensation Per Capita (Right) **Chart 4**





Source: Ministry of Health, Labour and Welfare, Ministry of Internal Affairs and Communications, Cabinet Office, Japanese Trade Union Confederation (RENGO); compiled by DIR.

Note: Base-pay increase rate shown in the chart at the left is based on the Ministry of Health, Labour and Welfare's "Comprehensive Survey on Wages" through FY2014, and aggregated result of responses released by the Japanese Trade Union Confederation (RENGO) after FY2015. Scheduled cash earnings of general workers on a y/y basis were calculated based on the Ministry of Health, Labour and Welfare's "Basic Survey on Wage Structure" through 1993, and the "Monthly Labour Survey" after 1994. FY2024 is an estimate. On the right side of the chart, employee compensation per capita is seasonally adjusted and on a y/y basis. Dotted lines are DIR estimates.

As for capital expenditure, we expect to see investment in renewal and capacity expansion, which companies had been postponing due to the Corona crisis and high prices, to emerge amid a continued accommodative financial environment. In addition to investment in labor saving and the decrease in the relative cost of capital associated with aggressive wage hikes on the part of corporations, software investment associated with the digital transformation (DX) and the green transformation (GX), as well as R&D investment are also expected to increase. On the other hand, caution should be exercised with the possibility that increased uncertainty over the outlook for overseas economies and delays in construction due to the shortage of labor will dampen capex.

The growth rate of government consumption is expected to remain somewhat low in FY2025 due to a reactionary decline in comparison to the robust performance of FY2024 amongst other factors, but as aging of the population progresses, and the pressures of growing medical and nursing care payments increase, growth is expected to accelerate through FY2026.

As for exports, goods exports are expected to feel the effects of the pause in recovery of the silicon cycle in the middle of 2025, and then enter an adjustment phase in the last half of 2026, but even so, performance should remain positive overall backed by stable growth in the global economy. Meanwhile, in services exports, continued expansion of inbound demand, as well as the increasing trend in business services are expected to provide underlying support.

2. Key Points in the Future of Japan's Economy

Major supporting factors, boosts and downside risks to Japan's economy

Chart 5 brings together a list of major supporting factors and boosts to Japan's economy, as well as downside risks based on recent developments.

Supporting factors and boosts to the economy

As was noted in our previous outlook, factors expected to influence Japan's economy through FY2026 include improvements in the household income environment due to wage hikes, government economic measures, continuation of an accommodative financial environment, growth in inbound demand, the high level of household savings, and the recovery of the silicon cycle. Prices and our outlook for the Bank of Japan's monetary policy will be discussed in more detail later in this report.We expect the CPI growth rate to maintain a stable level at around 2% y/y, and for the Bank of Japan (BOJ) to implement additional interest rate hikes at a moderate pace.

As mentioned previously in this report, real employee compensation per capita was on the plus side on a y/y basis for the third consecutive quarter in the Oct-Dec period of 2024, and is expected to remain in the positive range in the Jan-Mar period of 2025 and beyond due to the high level of wage hikes as a result of the spring labor negotiations as well as other factors (Chart 4, right). Meanwhile, on the government policy side, expansion of the child allowance at a scale of 1.3 tril yen annually[4] began in October 2024 (with payment in December), and measures to address the "1.03-million-yen barrier" will bring an increase in the basic deduction along with other factors, leading to further improvements in the income environment.

Regarding the comprehensive economic measures approved by the cabinet on November 22, 2024 by the Shigeru Ishiba administration, the economic effects are expected to be about 6.8 tril yen in cumulative terms over the next three years or about 0.4% in terms of real GDP per year. The Cabinet Office estimates this at around 21 tril yen (about 1.2%), and we estimate the economic effect at about 1/3 that of the government's estimate. This is because according to our thinking, the way in which GDP will be increased differs in the case of each policy[5]. Looking at the breakdown of economic effects, benefits for low-income households and resumption/extension of measures against high energy prices and other factors are expected to provide underlying support for private consumption. Meanwhile, measures for disaster prevention, disaster mitigation, and building national resilience, as well as recovery and reconstruction projects in the Noto region, will boost public investment. Labor-saving investments to address labor shortages and improve productivity, and strengthened support for the growth of the AI and semiconductor industries will promote related capital investment.

While these economic measures are expected to provide underlying support for the Japanese economy for the time being, it will likely become extremely difficult to attain the fiscal consolidation target of getting the national/local government primary balance back in the black in FY2025. As we indicated in last month's report, *Japan's Economy: Monthly Outlook (Jan 2025)* (Japanese only), the primary balance is expected to be at around -14.3 tril yen (nominal GDP ratio -2.3%) in FY2025.

---

[4] Income restrictions will be eliminated and the payment period was extended to high school age. The monthly allowance will be 15,000 yen for children aged 0 to 2, 10,000 yen for children aged 3 to high school age, and 30,000 yen for the third and subsequent children, regardless of age.

[5] In calculating the economic effects, we referred to data and other materials associated with the supplementary budget and divided the budget into amounts for each policy, then multiplied these amounts by a constant coefficient (a ratio associated with boosting GDP) and accumulated the results. However, policies which are difficult to connect directly to an increase in GDP over a period of three years due to their nature, and measures to address the "1.03-million-yen barrier" by increasing the basic income tax deduction whose details had not been worked out as of the time of writing this report, were excluded from the estimate.

Major Supporting Factors, Boosts and Downside Risks to Japan's Future Economy — Chart 5

Factors Supporting and Boosting the Economy

○ Improvements in Household Income Environment Due to Wage Hikes and Other Factors

Real wages (real employee compensation per capita), which experienced positive growth in y/y terms for three consecutive quarters through the Oct-Dec period of 2024, are expected to **continue rising (at the same level as labor productivity at around +1%).** The rate of wage hikes in the **spring labor negotiations in FY2025**, may be at the **same level as the previous year** at around **5.0%** (based on Japanese Trade Union Confederation aggregated result). Meanwhile, the **child allowance was enhanced** at a scale of **1.3 tril yen annually** from October 2024 (payment in December), and the **basic deduction** on income taxes will be raised along with other factors.

○ Government Economic Policy

The economic effects of the Ishiba administration's economic measures are **expected to be 6.8 tril yen over the next three years**. Payment of **benefits centering on low-income households, resumption/extension of the high energy price measures, and strengthening national land resilience** (against natural disasters), will provide underlying support for the economy, but It will likely become **increasingly difficult to attain the fiscal consolidation target** of getting the national/local government primary balance back in the black in FY2025.

○ Continuation of Accomodative Monetary Policy

Core CPI less fresh food and energy is expected to **maintain around +2% y/y**. We assume that the Bank of Japan (BOJ) **will raise** the short-term interest rate **to 0.75% in the Jul-Sep 2025 period (monthly for July),** followed by **additional rate hikes at a pace of once every six months, 0.25%pt at a time** (real short-term interest will remain in **negative territory**).

○ Growth in Inbound Demand

The number of foreign visitors to Japan was **36.87 million in 2024**, and is expected to reach **46 million in 2025** and **48 million in 2026**. Real inbound consumption amount is expected to grow from 6.7 tril yen in 2024 to **7.9 tril yen in 2025, and then to 8.3 tril yen in 2026.** The **number of visitors from China** is expected to **fully recover** in 2025, and this should help maintain growth momentum, but recovery is expected to be moderate in 2026.

○ High Level of Household Savings

Since the **end of December 2021**, just before the decline in real wages, household financial assets have recently **grown by +137 tril yen** as of **the end of September 2024** (+113 tril yen on a net basis excluding liabilities). With the recent comeback in the stock market, consumption may get a boost from the **wealth effect**.

○ Recovery of the Silicon Cyle

The silicon cycle is expected to **peak out in the middle of 2025,** and **enter an adjustment phase in the second half of 2026**. The balance of shipments and inventories in the electronic components and devices industry in Taiwan and South Korea, which have a high market share in advanced semiconductors, are showing signs of peaking out. Over the next four years there may be moderate growth in semiconductor sales due to the effect of the expansion of investment in AI in the US.

Downside Risks to the Economy

○ Downturn in US Economy Due to "Trump 2.0" and Long-Term Monetary Tightening

A second Trump administration will bring additional tariffs and strengthen immigration restrictions while cutting spending, and expanding investment in AI, which could **shrink the US GDP by a maximum of 1.2%pts** between 2025 and 2029. Even if a moderate policy is adopted, **if inflation reignites** and monetary tightening moves into the long-term, it could lead to **recession and a correction in stock prices**. (Stock price lows as have been seen in past recessions could lead to a negative wealth effect and cause **the US real GDP to decline by 0.8%**.)

○ Suppression of Economic Activity Due to Intensification of US-China Conflict and Strengthening of Ecomonic Security Measures

Full-fledged restrictions on Japanese exports of semiconductor manufacturing equipment to China will cause **Japan's exports to decline by over 2 tril yen**. **If Japan participates in US restrictions on investments in China (implemented in January 2025), China could strengthen its export restrictions on important materials such as rare earths** as a retaliatory measure.

○ Growing Tensions in the Middle East and Ukraine

If the price of crude oil were to rise to 150USD/bbl, **the impact on Japan's real GDP (annual basis) would be around ▲0.6%.**

○ Rapid Appreciation of the Yen

The effect on Japan's real GDP if the yen appreciates by 10 yen to the dollar (on an annual basis) would be **around ▲0.2%.** Differences in the directions of the monetary policies of the US and Japan and economic recession in the US will also make **purchasing power parity (around 90-130 yen/dlr)** more noticeable.

○ Emergence of China's Excessive Debt Problem

China's **excess capital stock totals 2,840 tril yen** (deviation of the capital coefficient from its long-term trend) due to stagnant technology and other factors.

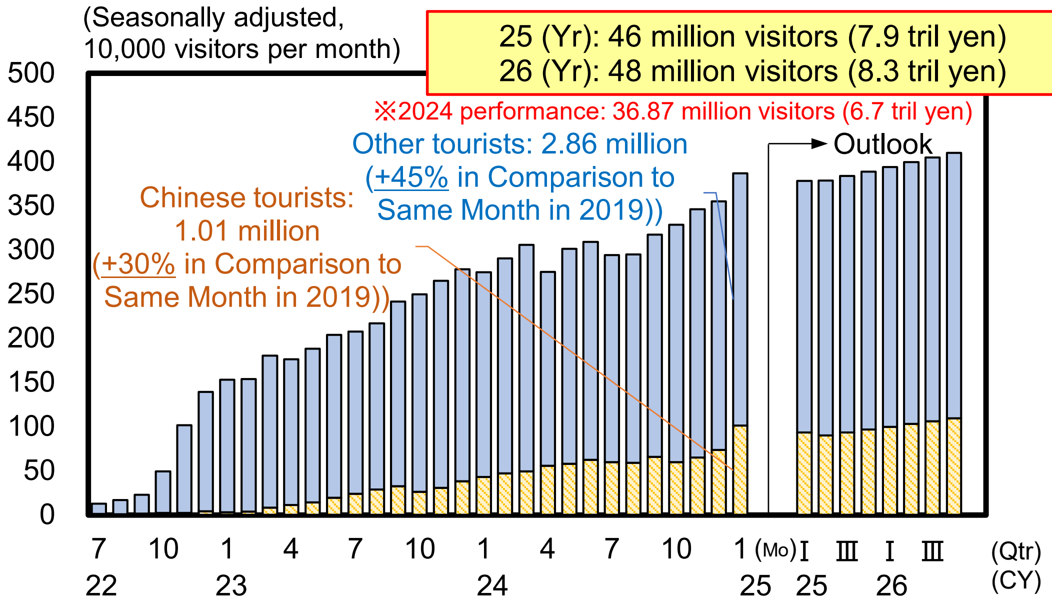
Source: Various Sources; compiled by DIR.

Inbound demand has experienced a strong recovery since the fall of 2022, but the slow recovery in the number of visitors from China due to the slowdown in China's economy was a drag on overall performance. The pace of recovery remained sluggish at the beginning of 2024. However, since the fall of 2024, the exchange rate moved again to a weaker yen, encouraging a significant increase in visitors to Japan from Korea and North America. In addition, airlines expanded the number of flights between Japan and China at the end of the year, leading to a major increase in the number of tourists visiting Japan from China, and an acceleration in the pace of recovery in the number of foreign tourists visiting Japan.

The Japanese government announced plans to ease entry visa requirements for Chinese visitors to Japan in December 2024. Recently, in January 2025, partly due to effects of the Chinese New Year vacation[6], the number of visitors to Japan from China exceeded the level reached in the same month of 2019 for the first time since the COVID-19 pandemic, +30% compared to the same month in 2019 (compared to -15% in December 2024). Looking at trends in the number of Chinese tourists visiting countries around the world (major destinations) through the end of 2024 suggests that although the Chinese are still keeping down overseas travel with China's economic slowdown, Japan is being chosen more than ever as a travel destination at this time.

In light of these circumstances, we have revised our outlook for inbound demand upwards in comparison to our previous report. We expect the number of foreigners visiting Japan, which was at 36,870,000 in 2024 (real consumption amount 6.7 tril yen), to grow to around 46,000,000 in 2025 (real consumption amount 7.9 tril yen), and around 48,000,000 in 2026 (real consumption amount 8.3 tril yen) (Chart 6).

Changes in Number of Foreign Visitors to Japan and Future Outlook (Amounts Shown in Parenthesis Are Real Consumption Amounts) **Chart 6**



Source: Japan Tourism Agency, Cabinet Office; compiled by DIR.
Note: Seasonally adjusted by DIR.

The high level of household savings is expected to continue providing underlying support for personal consumption. Since the end of December 2021, before the decline in real wages, household financial assets have grown by +137 tril yen, reaching 2,179 tril yen as of the end of September 2024 (+113 tril yen on a net basis excluding liabilities, totaling 1,787 tril yen). Immediately after its inauguration the Trump administration was aggressive in its tariff policy, and the sense of uncertainty regarding the future

[6] Keep in mind that China's New Years vacation period differs between 2019 and 2025 (Feb. 4-10 in 2019, and Jan. 28 – Feb. 4 in 2025).

of global trade strengthened rapidly. Since then, however, the financial markets have been maintaining a steady tone in response to the expansion of investment in AI and the promise of deregulation. If the real economy maintains a steady tone in the future and stock prices show a clear recovery, domestic personal consumption may get a boost from the asset effect.

The silicon cycle as seen in global semiconductor sales experienced a slowdown in the pace of recovery in December 2024. The same developments can be seen in the domestic index of industrial production for electronic parts and devices and indices such as the balance of shipments and inventories in the electronic components and devices industry in Taiwan and South Korea, which have a high market share in advanced semiconductors and other products. In addition, the leading SOX Index (the PHLX Semiconductor Sector Index™), has recently been declining. Considering the fact that the silicon cycle tends to last around four years, global semiconductor sales will likely show a clear movement toward peaking out by the middle of 2025, and then may enter an adjustment phase in the second half of 2026. On the other hand, the expansion of investment in AI by the Trump administration may stimulate demand for semiconductors, and since investment plans generally run on a four-year basis, moderate growth may appear following the increase in investment.

Downside Risks to Japan's Economy

The major downside risks to Japan's economy are many, centering on overseas economies. Concretely speaking, these are "Downturn in US Economy Due to 'Trump 2.0' and Prolonged Monetary Tightening," "Suppression of Economic Activity Due to Intensification of US-China Conflict and Strengthening of Economic Security Measures," "Growing Tensions in the Middle East and Ukraine," "Rapid Appreciation of the Japanese Yen," and "Emergence of China's Excessive Debt Problem" (Chart 5)[7].

For the time being, the major risk to Japan's economy and the global economy is the policies of the Trump administration, known as "Trump 2.0." A measure to uniformly impose an additional tariff of 10% on imports from China to the US was initiated on February 4, 2025. President Trump signed executive orders to introduce additional tariffs of 25% on steel and aluminum products imported into the US, and reciprocal tariffs, and is now considering a 25% tariff on automobiles. In addition, the administration is active in strengthening policy against illegal immigration and cutting back on government personnel. These policies are expected to have a negative impact on the US economy, but on the other hand, increased AI-related investment and deregulation are also expected, so we need to look at the positive effects of "Trump 2.0" as well.

According to our main scenario, there are elements in the various Trump administration policies that will moderate the negative effects on the US economy. However, even if the US economy maintains a steady tone, if inflation reignites and monetary tightening moves into the long-term, it could lead to recession and an adjustment in asset prices. In this regard, if stock price lows occur at the same level as past periods of recession, the US real GDP is estimated to be reduced by around 0.8% through the negative wealth effect[8].

The effects of "Trump 2.0" on the economy are illustrated in Chapter 4 of our report of 21 February 2025, *Japan's Economic Outlook No. 224 Update* (Japanese only). The results of our estimates are

[7] For more background on the effects of "Growing tensions in the Middle East and Ukraine" on the high price of crude oil, and "Emergence of China's excessive debt problem," see our report dated 11 March 2024, *Japan's Economic Outlook No. 220 Update* (Japanese only). For more detail on "Rapid Appreciation of the Yen," see our report dated 9 September 2024, *Japan's Economic Outlook No. 222 Update* (Japanese only).

[8] This estimate was calculated by multiplying the average stock price decline during past US recessions by the elasticity of the US consumption function shown in Chart 4-9 in our report dated 8 September 2021, *Japan's Economic Outlook No. 210 Update* (Japanese only).

shown in Chart 7[9]. Here we provide three hypothetical scenarios – moderate, risk, and tail risk – associated with each of the four major policies of "Trump 2.0" (tariff policy, Department of Government Efficiency, immigration policy, and AI related investment).

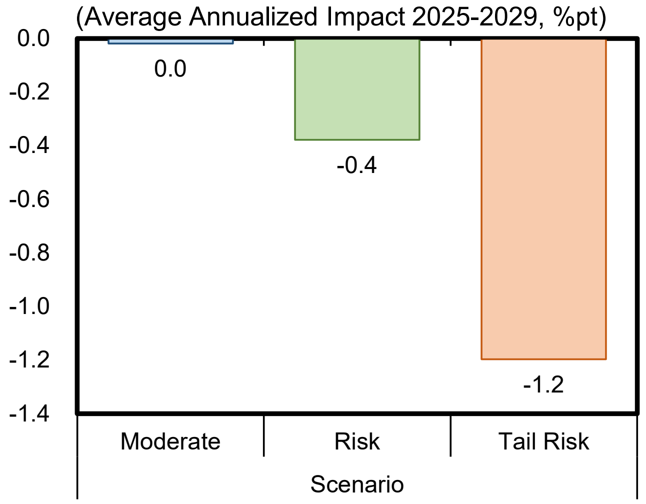
Of these, in the moderate scenario, the impact on the US real GDP growth rate from 2025 to 2029 would be limited to -0.0%pt per year, compared to a scenario in which the policies are not implemented, and the impact on the Japanese economy would be similar. On the other hand, in the risk scenario the effect on US and Japanese real GDP growth rate would be -0.4%pt, with the tail risk scenario pushing down growth rate significantly by -1.2%pt in the case of the US and -0.9%pt in the case of Japan.

These estimates do not take into consideration the effects of reciprocal tariffs and others whose details had not yet become clear at the time this analysis was produced. When tariffs are actually implemented, there is a risk that they will push the growth rate down further. There is a great deal of uncertainty, and it is necessary to keep a close eye on future developments of "Trump 2.0" and its impact on economic activity.

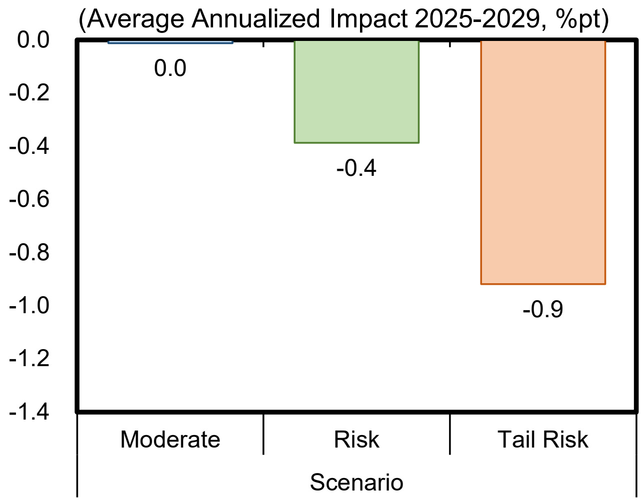
[9] We considered the effects of "Trump 2.0" on the US economy before the US presidential election in our report dated 10 June 2024, *Japan's Economic Outlook No. 221 Update* (Japanese only). In our current estimates we have included the effects of major policies which have recently become clear, dividing them into three scenarios. In addition, we included the effects of various policies on demand and supply, and used the FRB/US model (the FRB's macro model for the US economy) to grasp the correlation between economic variables in a consistent manner.

Impact of Major "Trump 2.0" Policies on US and Japan Real GDP Growth Rate (2025-2029 Annualized) (Top), Descriptions of Three Scenarios and Their Assumptions (Bottom) Chart 7

< US >



< Japan >



		Moderate Scenario	Risk Scenario	Tail Risk Scenario
Tariff Policy	Raising of Tariff Rate (Retaliatory Tariffs)	**No additional tariff policy** (10% tariff on Chinese goods has been implemented at this time – additional tariff only) *Not included in assumptions as details on reciprocal tariffs were unknown at time of analysis.	Following measures to be implemented in Jan.-Mar. 2025: ✓ **25%** tariff imposed on Canada and Mexico, **25%** additional tariff imposed on China. ✓ **Product-specific tariffs** on rest of the world ・25% tariff on steel and aluminum products The following measures to be implemented in Apr.-Jun. 2025: ✓ **Product-specific tariffs** on rest of the world ・10% tariff on oil and natural gas ・25% tariff on automobiles, semiconductors and pharmaceuticals	In addition to **risk scenario**, the following measures are ✓ **10% baseline tariff** ✓ Tariff **on Chinese** goods **raised to 60%**
Dept. of Govt. Efficiency	Cutting Govt. Spending	Of CBO estimated spending cuts, only **non-military budget (approximately 0.9 tril dlrs)** to be realized over next **ten years.**	CBO estimated spending cuts **(maximum 2.2 tril dlrs)** to be implemented over next **ten years**	Spending cuts of **1 tril dlrs annually** (Musk guideline) to be reached by end 2028
	Personnel Reduction	**5%** of govt. personnel to retire by end September 2025	**7.5%** of govt. personnel to retire by end September 2025, expand to maximum of **10%** by end 2028	**10%** of govt. personnel to retire by end September 2025, expand to maximum of **25%** by end 2028
Immigration Policy		**Stop entry** of illegal immigrants, **deport 250,000 people per year** through 2028 (largest number in past ten years)	**Stop entry** of illegal immigrants, **deport** approximately 2 million people with a criminal record or who have received orders of deportation by end 2028 (**500,000 people annually**)	**Stop entry** of illegal immigrants, **deport** current illegal immigrants, approximately 11 million people, At the same pace as when the inflow was at its maximum (**2.4 million people annually**). **Reduce** number of **legal immigrants by half** (a reduction of 400,000 per year).
AI Related Investment		AI investment by Softbank Group and others (**500 bil dlrs over a period of five years**, 100 bil dlrs per year) to be carried our according to plan. Effects of AI related investment on improvements in labor productivity: **0.9%pt annually x weight of investment**	AI investment plans fall behind (**500 bil dlrs over a period of ten years**, 50 bil dlrs per year) Effects of AI related investment on improvements in labor productivity: **0.4%pt annually x weight of investment**	AI investment plans fall behind (**500 bil dlrs over a period of ten years**, 50 bil dlrs per year) Effects of AI related investment on improvements in labor productivity: **0.1%pt annually x weight of investment**

Source: Various sources; compiled by DIR.
Note: For details see Chapter 4 of our report dated 21 February 2025, *Japan's Economic Outlook No. 224* (Japanese only)

3. Outlook for Prices and Monetary Policy

New core-core CPI expected to maintain steady pace at around +2% y/y through FY2025

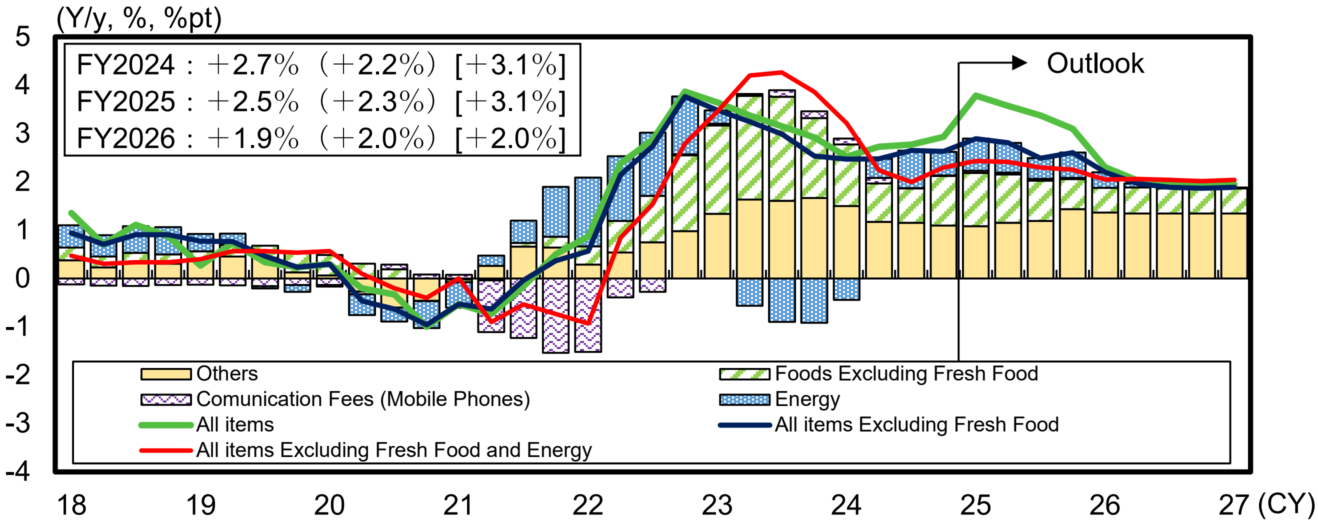
On an all items basis, core CPI is projected to increase by +3.1% y/y in both FY2024 and FY2025, with +2.0% expected in FY2026 (Chart 8). On an all items basis, less fresh food, core CPI is projected to increase by +2.7% y/y in FY2024, +2.5% in FY2025, and +1.9% in FY2026. Meanwhile, on an all items basis, less fresh food and energy (new core-core CPI), the forecast is +2.2% in FY2024, +2.3% in FY2025, and +2.0% in FY2026.

Prices have continued to be on the rise for certain foodstuffs such as rice but this trend is expected to gradually settle down. On the other hand, the trend of passing on increased labor costs to sales prices will continue, and the cyclical increase in wages and prices will become well established, hence underlying prices will remain stable at around +2% y/y.

As for energy, measures to reduce the burden of electricity and gas bills (electricity and gas bills to be supported from January through March 2025) are to be implemented, and the fuel subsidy program to curb extreme price increases (gasoline subsidy) will be extended, though the amount of support will be gradually reduced. Countermeasures against high energy prices will likely become a factor bringing downward pressure on the CPI growth rate for some time to come.

Details are provided later in this report, but the major cause of price increases has shifted from growth in intermediate input costs (the first force according to the BOJ[10]), to growth in personnel expenses (referred to as the second force). Behind this is the structural issue of the worsening labor shortage, hence the move toward wage hikes on the part of corporations will likely continue. The trend of passing on the associated increase in labor costs to sales prices will also continue.

Outlook for CPI (Excluding Fresh Food; Figures in Parenthesis Excluding Fresh Food and Energy)
Chart 8



Source: Ministry of Internal Affairs and Communications; compiled by DIR.
Note: Price outlook assuming resource prices and exchange rates at the time of preparation. Assumes that subsidies for electricity and gas will be implemented from January through March 2025, and the fuel subsidy program to curb extreme price increases (gasoline subsidy) will gradually be reduced for the over 185 yen/liter range.

[10] Speech by Governor UEDA in Osaka (Japan's Economy and Monetary Policy) : Bank of Japan (2023/9/25)

Passing on increase in labor costs to sales prices expected to continue

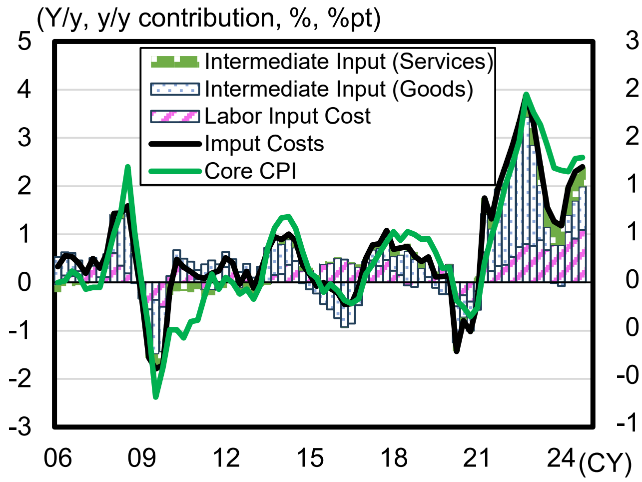
Chart 9 left shows changes in corporate input costs estimated from the input-output table and various wage and price statistics, as well as core CPI. The two are highly interlinked, and the factors that cause CPI to rise can be captured in terms of input costs.Around 2022 and 2023 when the core CPI growth rate rose rapidly, we can see that the extent of contribution to growth from intermediate inputs (goods) was large. However, more recently, the extent to which intermediate costs are pushing up CPI is gradually being reduced, and the influence of labor input costs is on the rise.

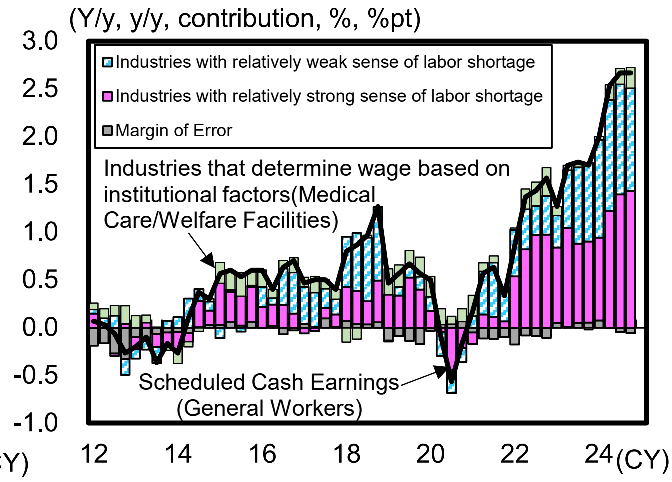
Recently, the contribution of intermediate inputs (goods) has been increasing again, but this trend is expected to be temporary. There is no change in our assessment that the main cause of price increases has shifted from the increase in intermediate input costs due to high import prices (the so-called "first force") to the increase in labor costs (the so-called "second force").

In considering the outlook for the rate of increase in core CPI, it is important to determine whether the increase in labor input costs will persist. In order to examine the background to the increase in labor input costs, Chart 9 right classifies the contribution of wages (y/y change in wages within a given year), which is a major labor input cost, by industry sector into those with relatively strong labor shortages and those with relatively weak labor shortages. The breakdown shows that in addition to industries with relatively strong labor shortages, such as the accommodation, eating and drinking services industry and the transportation and postal activities industry, the contribution of industries with relatively weak labor shortages is gradually increasing. This suggests that high wage hikes were implemented in a wide range of industries through 2024 against the backdrop of intensifying competition for human resources and the spread of “defensive wage hikes.”

Corporations are proactive in investing in labor-saving measures, but with the labor force about to peak out, it will be difficult to resolve in the short term. Wage increases to secure personnel and upward pressure on prices due to the passing on of increased labor costs are expected to continue[11].

Corporate Input Costs and Changes in CPI (Left); Breakdown of Scheduled Earnings (Right) Chart 9





Source: Cabinet Office, Bank of Japan, Ministry of Internal Affairs and Communications, Ministry of Health, Labour and Welfare; compiled by DIR.

Notes: 1) The input costs in the left side chart are weighted average values calculated by using the Corporate Price Index (Bank of Japan), Corporate Services Price Index (same source), Monthly Labor Survey (Ministry of Health, Labour and Welfare), etc. to calculate the rate of change in input costs for each industry from the intermediate input weights and labor input weights in the 2015 Input-Output Table, and then weighting the result by household final consumption expenditure weights.

2) The relatively strong and weak labor shortages in the right side chart are classified according to the Employment Conditions DI for each industry in the Bank of Japan's Tankan survey (actual result).

[11] By industry, however, it should be noted that the cyclical increase in wages and prices has lagged, especially in the household non-manufacturing sector. For details, see the DIR report dated 20 November 2024 by Kanako Nakamura and Shotaro Kugo, “Evaluation of Progress of ‘Virtuous Circle of Wages and Prices’ and Challenges to Establishing It” (Japanese only).

BOJ will raise short-term interest rate to 0.75% in July 2025, and subsequently raise rates at a moderate pace

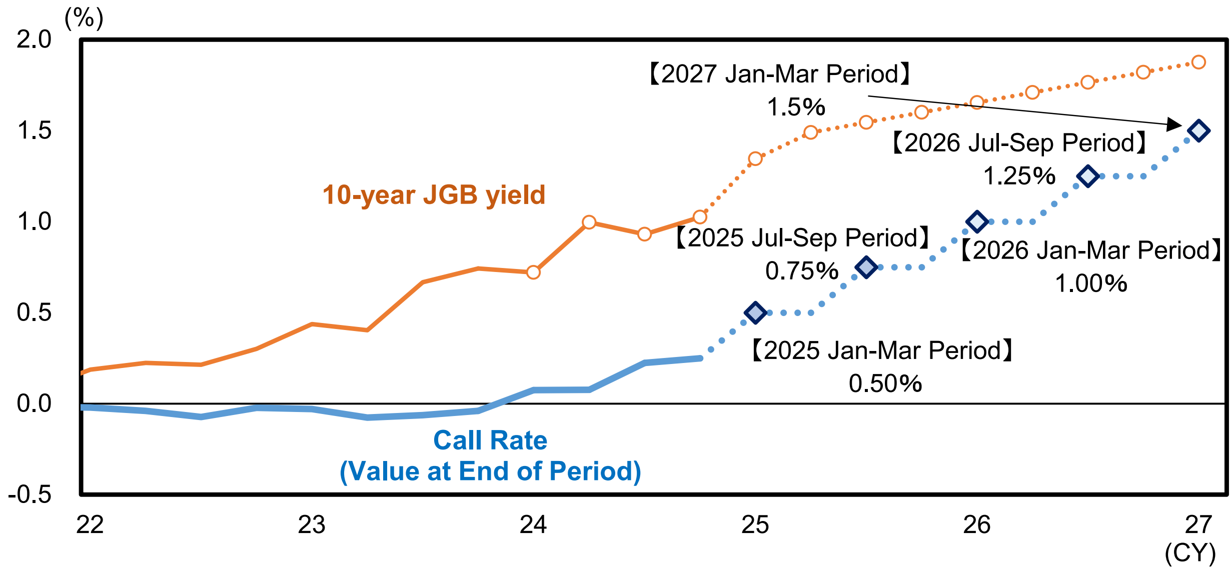
The BOJ decided to raise the short-term interest rate to 0.50% in January 2025, and we assume that they will implement additional interest rate hikes at a moderate pace while closely monitoring economic and price conditions. According to our main scenario, the short-term interest rate will be raised to 0.75% in the Jul-Sep 2025 period (in July on a monthly basis), followed by additional rate hikes at a pace of once every six months, 0.25%pt at a time (1.50% in the Jan-Mar period of 2027) (Chart 10).

The real short-term interest rate (found by subtracting the growth rate in prices from the call rate) is expected to rise gradually, but will remain in negative territory throughout the forecast period. Japan's natural rate of interest has recently been estimated to be at around zero[12]. With the real interest rate falling below the natural rate of interest (the real interest rate gap is negative), an accommodative financial environment is expected to be maintained throughout the forecast period.

As for the risk of additional interest rate hikes occurring sooner than our assumptions, this could occur if the yen weakens at a rapid pace. If the dollar-yen rate continues around the same level as recently (around 150 yen/dlr), it will not bring major upward pressure on growth in prices, but this will not necessarily hold in the case of major depreciation of the yen such as the rate's exceeding around 170 yen/dlr[13]. If the possibility of the CPI growth rate exceeding the price stability target of 2% by a great amount increases, the BOJ will most likely implement additional interest rate hikes earlier than planned, as a means of holding down the risk of rising prices.

In light of recent conditions, we have revised our outlook for the long-term interest rate upwards in comparison to our previous outlook. We now expect the long-term interest rate to rise to around 1.9% in the final stage of the forecast period (Chart 10). The BOJ's interest rate hikes will be a factor in pushing up long-term interest rates. On the other hand, we assume that the Fed will continue cutting interest rates in the US throughout the forecast period. US long-term interest rates are expected to decline gradually, which will bring downward pressure on Japan's long-term interest rate.

Outlook for Long and Short-Term Interest Rates in Japan **Chart 10**



Source: Ministry of Finance, Bank of Japan; compiled by DIR.
Note: The long-term interest rate is a period average, while the short-term interest rate is the value as of the end of the period. Dotted lines are DIR estimates.

---

[12] For details see our report of 11 March 2024 *Japan's Economic Outlook No. 220 Update* (Japanese only).
[13] For details see our report of 9 December 2024 *Japan's Economic Outlook No. 223 Update* (Japanese only).

When long and short-term interest rates rise, net interest income increases for households and financial institutions, while it decreases for corporations and the government

When interest rates rise, how are various economic entities affected? Chart 11 shows the results of estimates of the effect on net interest income when long and short-term interest rates rise by 0.25%pt[14]. Here, the total net interest incomes of households, corporations, government, and the BOJ are estimated to match the net interest income of financial institutions, including the overseas sector (inverse sign).

Household net interest income grows when either short-term or long-term interest rates rise, but the amount of growth is higher in the case of short-term interest. On the liabilities side, the burden of interest payments grows when interest on mortgages and other loans rises. On the other hand, on the asset side, interest on regular savings and new time deposits, which are strongly influenced by short-term interest rates, will rise, leading to growth in net interest income, ultimately exceeding the amount of increase in interest payment burden. Looking at household net interest income by age of head of household, the benefits of rising interest rates are concentrated in elderly households, which have a high level of ownership of net financial assets, while households mainly in their 30s and 40s with mortgages and other loan payments feel their lifestyles under pressure from the increase in interest payment expenses.

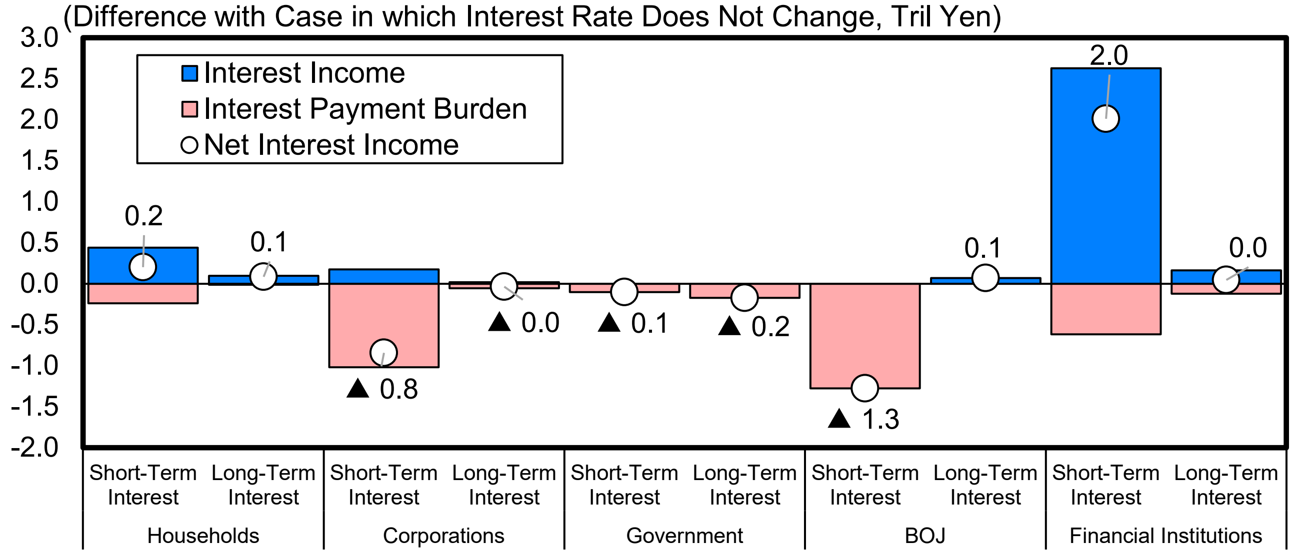
In the case of financial institutions, the increase in net interest income is greatest in the case of growth in the short-term interest rate. Growth in net interest income for households and corporations means an increase in interest payment burden for financial institutions, but growth in the short-term interest rate also means growth in interest income from loans made to corporations and other entities, and from current account deposits at the BOJ.

Looking now at corporations and the government, net interest income declines in either case. In the case of corporations, the amount of debt carried tends to exceed that of deposits, hence a rise in the interest rate can easily bring an increase in interest payment burden rather than interest income. The effects of the short-term interest rate are more easily felt than the long-term interest rate. In contrast, the government is more easily influenced by growth in the long-term interest rate. This is because interest payment expenses on newly issued government bonds increase.

The BOJ’s net interest income declines when there is a rise in the short-term interest rate, and grows when there is a rise in the long-term interest rate. A rise in the short-term interest rate increases the interest payments made by the Bank of Japan to financial institutions through higher interest rates on BOJ current account deposits, while a rise in the long-term interest rate increases the BOJ's interest income through the purchase of newly issued government bonds.

[14] For details on estimation method, see our report *Japan’s Economy: Monthly Outlook (Apr 2023)* (Japanese only).

Effect of 0.25%pt Rise in Short-Term & Long-Term Interest Rates on Net Interest Income — Chart 11



Source: Bank of Japan, Japan Housing Finance Agency, Japanese Bankers Association; compiled by DIR.
Note: Financial institutions include the overseas sector. Items that are affected by short-term and long-term interest rates were extracted from the assets and liabilities of each economic entity, and interest income and interest payment amounts calculated using coefficients obtained by regressing the applicable interest rates on short-term and long-term interest rates to calculate the amount of interest income and interest payment amounts when short-term and long-term interest rates rise by 0.25 percentage point.

Japan's Economic Outlook No. 224 (February 21, 2025) — Chart 12

		2024			2025				2026				2027	FY2024 (CY)	FY2025 (CY)	FY2026 (CY)
		Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar			
Real GDP	Y tril; annualized	556.4	558.7	562.5	563.1	565.0	566.7	568.4	570.0	571.4	572.9	574.3	575.6	560.1	567.5	573.5
	Q/q %	0.7	0.4	0.7	0.1	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.2			
	Q/q %; annualized	3.0	1.7	2.8	0.4	1.4	1.2	1.2	1.1	1.0	1.0	1.0	0.9			
	Y/y %	−0.8	0.6	1.2	1.9	1.6	1.4	1.1	1.3	1.1	1.1	1.0	1.0	0.7	1.3	1.1
														(0.1)	(1.5)	(1.1)
Private Consumption	Q/q %	0.7	0.7	0.1	0.2	0.4	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.8	1.3	0.9
Private Residential Investment	Q/q %	1.4	0.5	0.1	−0.6	−0.5	−0.5	−0.6	−0.6	−0.7	−0.7	−0.8	−0.8	−1.2	−1.7	−2.7
Private Non-Resi. Investment	Q/q %	1.1	−0.1	0.5	0.5	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.5	2.0	2.0	1.9
Government Consumption	Q/q %	0.9	0.1	0.3	0.1	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.3	1.5	0.7	1.3
Public investment	Q/q %	5.7	−1.1	−0.3	−0.2	0.1	0.3	0.3	0.1	0.1	0.1	0.1	0.1	2.0	−0.1	0.5
Exports	Q/q %	1.7	1.5	1.1	0.6	0.6	0.6	0.7	0.7	0.7	0.7	0.7	0.6	1.9	2.9	2.7
Imports	Q/q %	3.0	2.0	−2.1	1.1	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6	3.2	1.7	2.5
Nominal GDP	Q/q %; annualized	8.9	3.0	5.1	2.0	3.0	2.6	2.5	2.3	2.2	2.2	2.1	2.1	3.5	2.9	2.3
GDP deflator	Y/y	3.1	2.4	2.8	2.7	1.7	1.8	1.4	1.4	1.3	1.2	1.2	1.1	2.8	1.6	1.2
Industrial production	Q/q	2.7	−0.4	1.1	0.0	1.1	0.9	0.7	0.4	0.4	0.3	0.3	0.3	−0.8	2.7	1.7
Core CPI	Y/y	2.5	2.7	2.6	2.9	2.8	2.5	2.6	2.2	2.0	1.9	1.9	1.9	2.7	2.5	1.9
Unemployment rate	%	2.6	2.5	2.5	2.4	2.4	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.5	2.3	2.3
Trade balance (goods, services)	Y tril; annualized	0.08	0.23	0.25	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50	0.50	1.00	1.50
Current account balance	Y tril; annualized	1.00	0.93	1.03	1.35	1.49	1.55	1.60	1.66	1.71	1.77	1.82	1.88	1.07	1.57	1.79
Major assumptions																
Crude oil price (WTI futures)	$/bbl	80.7	75.3	70.3	73.1	72.3	72.3	72.3	72.3	72.3	72.3	72.3	72.3	74.8	72.3	72.3
Exchange rate	Yen/$	155.8	149.1	152.4	153.5	151.5	151.5	151.5	151.5	151.5	151.5	151.5	151.5	152.7	151.5	151.5

Source: Compiled by DIR.
Note: Shaded areas are DIR estimates. The price of crude oil and the exchange rate are assumed to be fixed at recent levels.