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Japan's Economy: Monthly Outlook (May 2025)

Economic Outlook Revised: Recovery expected, but wary of "Trump tariffs" and other factors

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Summary

- In light of the announcement of the Jan-Mar 2025 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 FY2025, and +0.9% in FY2026. (On a calendar year basis, we expect +0.9% in 2025 and +0.9% in 2026).

- While the level of uncertainty is great due to the US Trump administration's high tariff policy (Trump tariffs), we expect real wages (real employee compensation per capita) to remain on the positive side on a y/y basis, due to the continuation of wage hikes at a high level in the spring labor negotiations, and a decline in the rate of growth in prices. We also expect the growth rate trend in CPI to be stable at around 2%. 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 trends in the Trump tariffs and the impact they may have on domestic and global economic activity.

- We assume that the Bank of Japan (BOJ) will raise the short-term interest rate to 0.75% in the Oct-Dec 2025 period (October in monthly terms) while closely monitoring the economy, prices, and financial situation, 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 1.25% by the end of the forecast period, the Jan-Mar period of 2027.

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

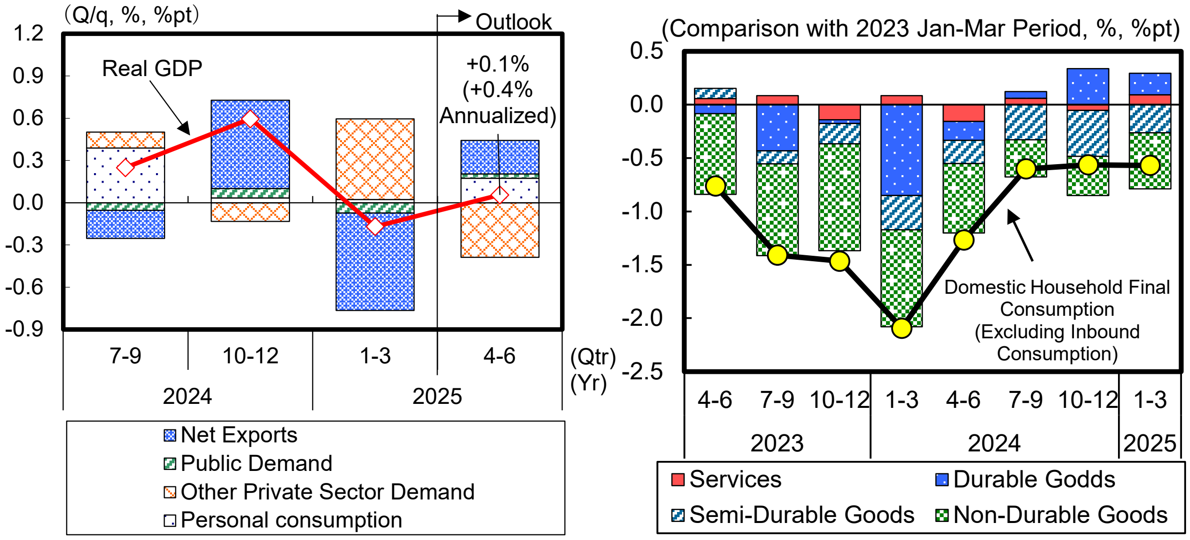
Real GDP registers negative growth for the first time in four quarters in Jan-Mar period of 2025

The real GDP growth rate for Jan-Mar 2025 (1st preliminary est) was down by -0.7% q/q annualized (-0.2% q/q), the first time in four quarters it has registered negative growth [1]. The main reason was a decline in net exports, though at the same time, private sector demand experienced growth. However, rising food prices have had an impact on personal consumption, with the pace of recovery in consumption slowing further and causing sluggish growth.

Looking at performance by demand component (Chart 1, left), all components in the area of private sector demand achieved growth, with private sector inventories contributing to GDP growth. As for public sector demand, both government consumption and public investment declined. Meanwhile, in the area of overseas demand, net exports declined as mentioned above, pushing down the real GDP growth rate by 0.8%pts.

Of these, private consumption grew slightly for the fourth consecutive quarter at +0.0%. However, the growth rate declined for the second consecutive quarter with the decline growth for non-durable goods in the Jan-Mar period especially standing out (negative range in the bar graph in Chart 1 right expanded). The non-durable goods deflator has accelerated significantly since the Oct-Dec period of 2024 (+0.5% q/q) at +4.0% q/q due to the high price of foods[2], leading to more economical consumption behavior centering on food products. In addition, other durable goods declined, particularly home appliances and automobiles. On the other hand, in services, eating out was strong and travel-related spending increased, while in semi-durable goods, spending on game consoles increased.

Real GDP Growth Rate Results & Outlook (Left); CPI & Trend in Personal Consumption by Goods & Services (Right) **Chart 1**



Source: Cabinet Office, Japan Tourism Agency; compiled by DIR.
Notes: Figures are seasonally adjusted. The graph on the right shows real figures, calculated based on the Japan Tourism Agency's "International Visitor Survey", by breaking down "Domestic Direct Purchases by Non-Resident Households" in GDP statistics by goods and services and subtracting them from domestic household final consumption expenditure.

Real employee compensation declined for the first time in six quarters at -1.3% q/q. According to the Ministry of Internal Affairs and Communications' Labour Force Survey, the number of employees increased by +0.3%, and real employee compensation per capita (≒real wages) divided by the number

[1] See the DIR report by Keiji Kanda and Munehisa Tamura dated 19 May 2025, *Jan-Mar 2025 1st Preliminary GDP Estimate*.
[2] Since deflators for domestic household final consumption expenditure by type are not published, the q/q change is calculated here from the deflator (seasonally adjusted), which is the nominal amount divided by the real amount.

of employees fell by -1.5%. In addition to a sharp acceleration in the rate of inflation, the effects of a significant increase in bonuses in the Oct-Dec period of 2024 were reflected in the results. Although the rate of increase narrowed to near zero on a y/y basis, it is expected to expand again from the Apr-Jun period onwards due to the effects of wage increases in the spring labor negotiations and a decline in the rate of inflation (Chart 3 right).

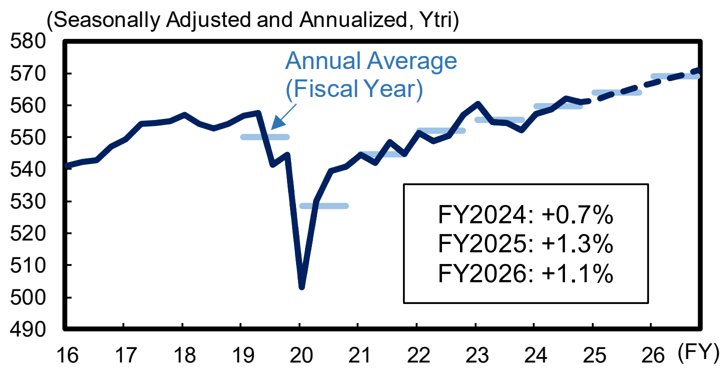
We expect Japan’s 2025 Apr-Jun period real GDP growth rate to increase by +0.2% q/q annualized (+0.1% q/q) (Chart 1 left). Depending on the direction of the Trump administration's high tariff policy (Trump tariffs) and the extent of its impact on domestic and overseas economic activity, there is also the possibility of negative growth for two consecutive quarters.

Summary of the overseas economic outlook and assumptions regarding Trump tariffs

Chart 2 (top) illustrates our main scenario for the trend in real GDP, based on our outlook for overseas economies. Our latest outlook for overseas economies dated May 23 is provided by our in-house expert on the overseas economy. For details see the economic outlooks for the various countries included.

There is an extremely high level of uncertainty regarding the Trump tariffs. Our main scenario considering this situation is based on the assumptions shown in Chart 2 (bottom). The additional tariffs on reciprocal tariffs, which are temporarily suspended until July 9, will not be applied even after that date due to progress in negotiations with the US. The current situation is reflected in the forecast period. On the other hand, the 10% baseline tariffs and tariffs on specific items such as automobiles, steel, and aluminum products will continue to be implemented as planned. The economic impact of the Trump tariffs will be quantitatively examined in Chart 4 and Chart 5 below.

Outlook for Japan’s Real GDP (Top) and Assumptions Regarding Overseas Economies (Bottom)
Chart 2



US, Eurozone & China
Real GDP Growth Rate

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

Assumption Regarding Trump Tariffs

Tariff Breakdown by Country and Region

○Reciprocal tariffs

・Baseline tariff (10%): **continued**

・Additional tariff: Depending on progress of negotiations with US, **these may not be applied during the forecast period.**

○Additional tariff on China : **30%**

○Tariffs on Mexico and Canada: **25%** (excludes USMCA compliant products, 10% on Canadian energy & resources)

Product-Specific Tariffs

○**To be continued**, including those planned for implementation (we assume 25% on semiconductors (including electronic devices), pharmaceuticals and other items)

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 experts.

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

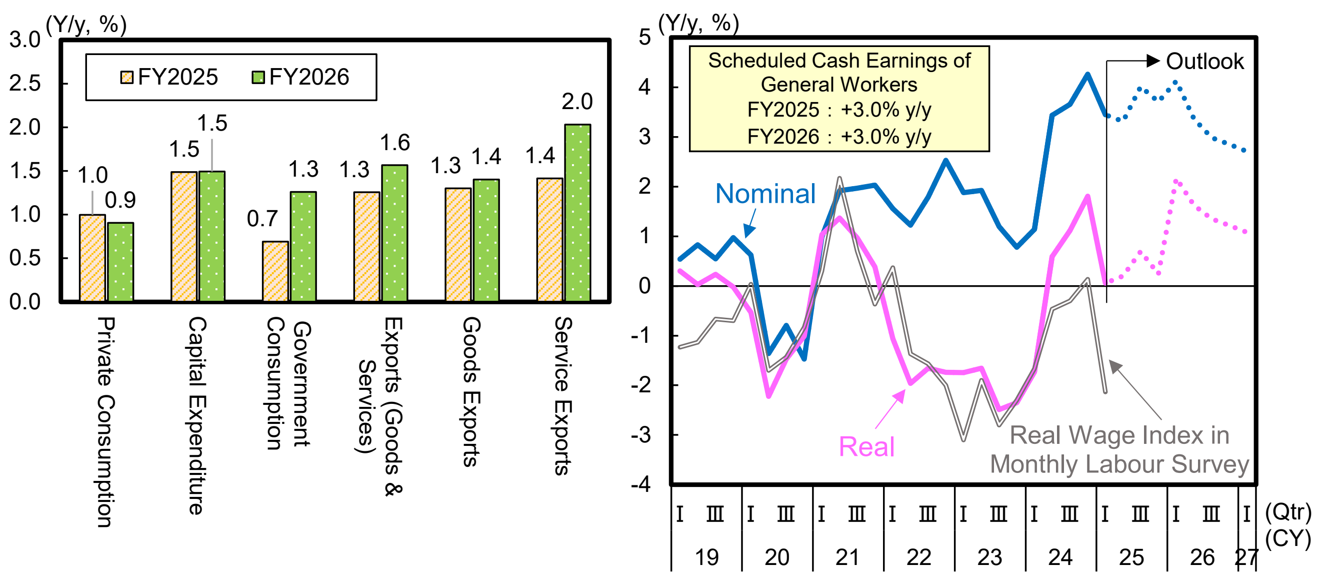
Based on the above overseas economic outlook, Japan's real GDP growth rate according to our main scenario is expected to be +0.7% y/y in FY2025, and +0.9% in FY2026 (Chart 2, +0.9% in 2025 and +0.9% in 2026 on a calendar year basis).

The outlook for the FY2025 growth rate was revised downwards by 0.5%pt from our report of March 11, 2025 (*Japan's Economic Outlook No. 224 Update* (Japanese only), hereafter "our previous outlook"). The extent of the downward revision excluding carryover (real GDP growth rate that can be achieved with zero q/q growth in each quarter) is expected to be 0.3%pt. In addition to our assumptions of a downturn in exports impacted by the Trump tariffs and a slow recovery in the average propensity to consume due to the increasing sense of uncertainty regarding the future, we included the recent delay of recovery for private consumption due to high prices of food products in our estimate. We also revised our outlook for capex downwards somewhat in consideration of the deterioration of the corporate earnings environment and the increasing sense of uncertainty regarding the future.

We have left our outlook for FY2026 unchanged from the previous one. We assume that, of the Trump tariffs, baseline tariffs and product-specific tariffs will continue in FY2026, and that they will continue to exert downward pressure on exports, capex, and related imports.

Major demand components are expected to perform as illustrated in Chart 3.

Outlook for Major Demand Components (Left), Outlook for Employee Compensation Per Capita (Right)
Chart 3



Source: Cabinet Office, Ministry of Health, Labour and Welfare, Ministry of Internal Affairs and Communications; compiled by DIR.
Note: The chart on the left shows real values. The chart on the right, values for employee compensation per capita are seasonally adjusted and on a y/y basis. The dotted lines are DIR estimates.

Of these, private consumption is expected to continue to maintain moderate growth. The high level of wage hikes in the spring labor negotiations is expected to continue from last year, and effects are expected to be felt to some extent. Meanwhile, the income environment is expected to improve due to a decline in the rate of increase in prices of food items and government economic policy (free higher education and measures against high energy prices)[3]. Although real employee compensation per capita

[3] According to the results of the fifth round of responses (released on May 8) by the Japanese Trade Union Confederation (RENGO), the weighted average rate of wage increases (including regular salary increases) was 5.32%, higher than the same period last year (5.17%). Even taking into account the tendency for wage increases to be revised downward in the final round of responses, it is highly likely that the rate of increase will exceed that of the previous year (5.10%) and land in the low 5% range.

slowed to about +0.1% y/y in the Jan-Mar 2025 period, we assume that it will remain in positive territory throughout the forecast period, mainly due to a significant acceleration in the rate of growth in prices (Chart 3, right). In addition, the high level of household savings[4] is expected to continue to support personal consumption.

As for capital expenditure, we expect to see growth maintained with the continuation of an 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. However, the possibility is great that the impact of the Trump tariffs could bring a major deterioration in corporate earnings while increased uncertainty over the outlook for overseas economies might dampen capex. Meanwhile, on the domestic front as well, caution is advised as construction investment could be sluggish due to delays in construction schedules caused by labor shortages.

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 will be up by +1.3% y/y in FY2025, but when carryover is excluded, growth will remain relatively small at +0.4%. In addition to the negative factor of the Trump tariffs, the recovery of the silicon cycle is expected to take a breather around the middle of 2025 and become a drag on growth. On the other hand, services exports are expected to maintain momentum. The pace in growth of inbound demand is expected to slow[5], but business services, etc. 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

Major factors expected to support and boost Japan’s economy include “improvements in the household income environment due to wage hikes and other factors,” “government economic measures,” “continuation of an accommodative financial environment,” “growth in inbound demand,” and “the high level of household savings.” Prices and our outlook for the Bank of Japan (BOJ)’s monetary policy will be discussed in more detail in Chapter 3 of this report. We expect the CPI growth rate to maintain a stable level at around 2% y/y, and for the BOJ to implement additional interest rate hikes at a moderate pace.

On the other hand, the downside risks to Japan’s economy are many, centering on overseas economies. Concretely speaking, these are “Downturn in US Economy Due to Trump administration policies (in other words ‘Trump 2.0’),” “Suppression of Economic Activity Due to Intensification of US-China Conflict and Strengthening of Economic Security Measures,” “Growing Tensions in the Middle East

[4] According to the Bank of Japan's “Flow of Funds Accounts Statistics,” household financial assets totaled 2,230 tril yen at the end of December 2024, the latest available data. This is an increase of 188 tril yen from the end of December 2021, just before the decline in real wages, and an increase of 159 tril yen on a net basis, excluding liabilities.

[5] The number of foreign visitors to Japan (Japan National Tourism Organization) is expected to increase from 36.87 million in 2024 to around 44 million in 2025 and around 47 million in 2026 (real inbound consumption will increase from 6.8 tril yen in 2024 to around 7.7 tril yen in 2025 and 8.0 tril yen in 2026). The increase is expected to be maintained in 2025 partly due to a full-fledged recovery in the number of Chinese visitors to Japan, but the recovery is expected to be only moderate in 2026.

and Ukraine," "Rapid Appreciation of the Japanese Yen," and "Emergence of China's Excessive Debt Problem" (see our previous outlook for details).

Below, we examine the quantitative effects of Trump 2.0 on the economy, centering on the high tariff policy. On the domestic side, we take a look at the proposal of the opposition parties, including the Constitutional Democratic Party of Japan, to lower the consumption tax on food items to zero percent.

Trump 2.0: Japan's economic structure, which is vulnerable to overseas demand, and limited policy response options pose risks to the economy

Main scenario predicts limited negative impact, but "pessimistic scenario" predicts severe impact

As has been mentioned previously in this report, our main scenario predicts that Japan will be able to avoid a major increase in the US tariff rate, and that its economy will continue to achieve moderate growth (Chart 2). However, looking at Trump 2.0 as a whole, including policies other than the tariff policy, there are still many uncertainties, and the risk of a downturn in the global economy remains high.

We have therefore created three scenarios – "Optimistic on Tariffs" (assuming moderate policies other than tariffs), "Moderate," and "Pessimistic" – for each of the key policies of Trump 2.0, and estimated their impact on the real GDP growth rates of Japan, the US, and the Eurozone. The results are shown in Chart 4.

Impact of US Trump Administration (Trump 2.0) Policies on Japan, US, and Eurozone Economies
Chart 4

Impact of Each Scenario on Real GDP Growth Rate (next five years, annualized)

Scenario	Japan	US	Eurozone
Optimistic on Tariffs	▲ 0.4%pt <▲ 0.4%pt>	▲ 0.2%pt <▲ 0.2%pt>	▲ 0.1%pt <▲ 0.1%pt>
Moderate	▲ 0.7%pt <▲ 0.6%pt>	▲ 0.4%pt <▲ 0.2%pt>	▲ 0.2%pt <▲ 0.1%pt>
Pessimistic	▲ 1.3%pt <▲ 0.8%pt>	▲ 1.3%pt <▲ 0.3%pt>	▲ 0.7%pt <▲ 0.2%pt>

*Figures represent the average impact on real GDP on a q/q annualized basis for the years 2025-2029

Figures in red represent impact of Trump tariffs only.

Major Assumptions of Each Scenario

Scenario	Tariff Policy	Dept. of Govt. Efficiency	Immigration Policy
Optimistic on Tariffs	✓ Reciprocal tariffs and product-specific tariffs: **10%** ✓ Tariffs on Canada and Mexico: **15%** ✓ **No retaliatory tariffs on other countries &regions**	✓ Non-military budget (**approx. 0.9 tril dlrs**) to be cut over next **10-years** ✓ **5%** of govt. employees to retire.	✓ Halt entry of illegal immigrants. ✓ Deport around **250,000 illegal immigrants per year.**
Moderate	✓ Reciprocal Tariffs: **50%** of additional tariff applied. ✓ Product-specific tariffs: **10%** ✓ **Retaliatory measures**, other tariffs continued.	✓ **Maximum 2.2 tril dlrs** to be cut over next **10-years**. ✓ **10%** of govt. employees to retire.	✓ Halt entry of illegal immigrants. ✓ Deport around **0.5 million illegal immigrants per year.**
Pessimistic	✓ Reciprocal Tariffs: additional tariff **applied fully.** ✓ Product-specific tariffs: **25%** ✓ **Retaliatory measures**, other tariffs continued.	✓ **1 tril dlrs** cut annually (Musk) **by end 2028.** ✓ **25%** of govt. employees to retire.	✓ Halt entry of illegal immigrants. ✓ Deport around **2.4 million** illegal immigrants per year. ✓ Cut legal immigration **by half.**

Source: Compiled by DIR based on statistics from a variety of sources.

Notes: 1) It is assumed that Canada and Mexico tariffs exclude USMCA compliant products. In addition, it is also assumed that Canadian energy and resources will have a 10% tariff applied. As for product-specific tariffs, it is assumed that tariffs will be applied to all products listed in Chart 5, including those which have not yet had tariffs applied.

2) For further detail on policies other than tariff policy, see Chapter 4 in our report of March 11, 2025 (*Japan's Economic Outlook No. 224 Update* (Japanese only)).

Overall, the major policies of Trump 2.0 are expected to have a negative impact on the US economy from the demand side, mainly in terms of personal consumption and imports and exports, as well as from the supply side, including labor and capital stock. The impact on real GDP growth in the US over the next five years will be limited to -0.2%pt per year under the optimistic tariff scenario (-0.2%pt with

Trump tariffs alone), but will increase to -0.4%pt (-0.2%pt) under the moderate scenario and -1.3%pt (-0.3%pt) under the pessimistic scenario. The Eurozone will be at -0.7%pt (-0.2%pt) under the pessimistic scenario.

The impact on Japan could be -1.3%pt annually under the pessimistic scenario (-0.8%pt under the Trump tariffs alone), which is more of a downturn than the Eurozone and comparable to the US, the epicenter. One of the reasons why Japan's economy could fall sharply is the structure of the Japanese economy, which is vulnerable to a decline in overseas demand. That is, when uncertainty in overseas economies increases, the yen, which is considered a safe currency, tends to be bought and appreciates, making exports vulnerable to a significant decline through two channels: a decline in overseas demand and an appreciation of Japan's currency.

In addition, the Japanese economy is also characterized by the little margin it has left in terms of policy response. Unlike central banks in major countries and regions that raised policy rates sharply in response to high inflation following the COVID-19 pandemic, the BOJ, which began normalizing monetary policy in March 2024, has only about an 0.5% margin to cut policy rates. In the event of a major negative demand shock, such as a sharp decline in overseas economies, an interest rate cut alone would not be sufficient.

If such a situation actually occurs, the BOJ is expected to implement unconventional monetary policies in addition to lowering interest rates. However, the BOJ itself pointed out in its "Review of Monetary Policy from a Broad Perspective" (December 19, 2024) that the policy effectiveness of unconventional monetary policies is less certain than that of interest rate cuts. For this reason, it is expected to be a policy mix with fiscal policy, but Japan's government debt-to-GDP ratio is exceptionally high compared to the rest of the world. It is important to note that if the government implements a large-scale expansion of government spending and tax cuts while the BOJ, which is the largest consumer of government bonds in the government bond market, continues to reduce its purchases of government bonds, it will be easier for upward pressure on long-term interest rates to occur than before.

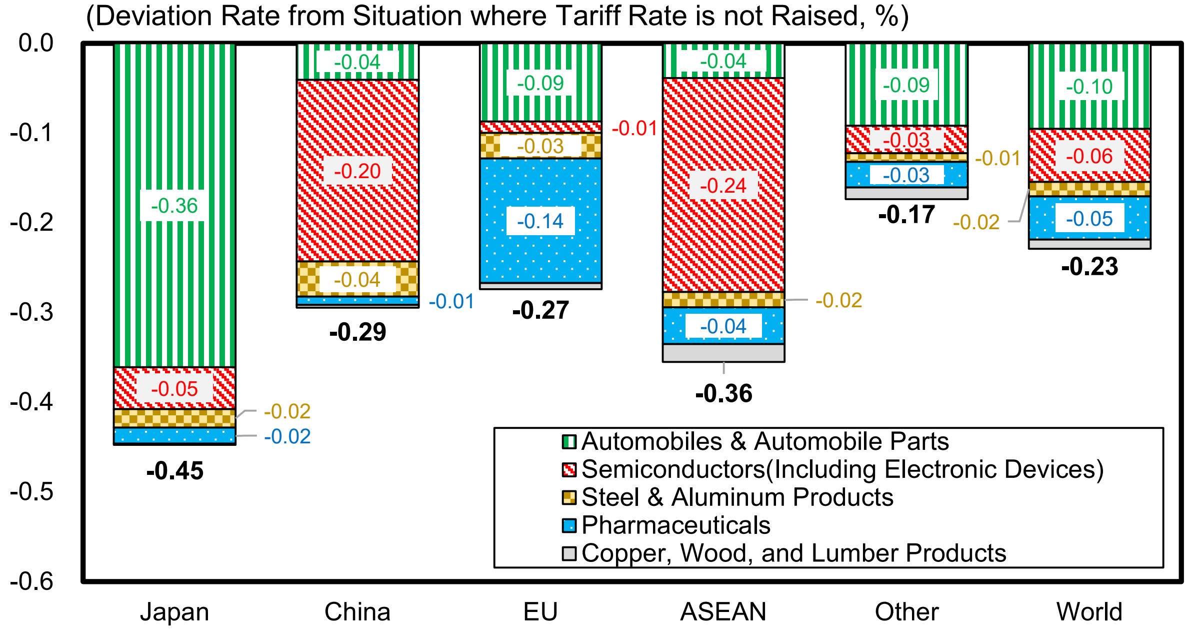
Product-specific tariffs could reduce Japan's real GDP by a maximum of 0.45%

Chart 5 shows the estimated impact of product-specific tariffs in the Trump tariffs on the real GDP of each country and region using the OECD's International Input-Output Table. Assuming that tariffs on items such as semiconductors and pharmaceuticals, the details of which are not yet known at the time of this writing, will be imposed at 25%, the same level as the existing tariffs, we estimate that Japan's real GDP will be pushed down by a total of about 0.45%[6]. This is about twice the amount of downward pressure seen for the entire world, and the impact of item-specific tariffs is large compared to other major countries and regions such as China and the EU.

Chart 5 shows that the impact of additional tariffs on automobiles and automobile parts is particularly large in Japan. Japan's automotive industry has a broad base, and the adverse effects could affect a wide range of industries. On the other hand, in the EU, pharmaceuticals, which are relatively large exports to the US, and in China and the Association of Southeast Asian Nations (ASEAN), the impact on semiconductors, including electronic devices, is expected to be significant.

[6] The Trump administration is also investigating the introduction of additional tariffs on commercial aircraft and parts, medium-size and large trucks, and critical minerals, although the detailed scope of coverage for each of these has not been disclosed. Therefore, in this report, we focus our analysis on those items for which it is possible to roughly estimate the scope of tariffs based on the list of items exempted from the reciprocal tariffs and other factors.

Impact of Product-Specific Tariffs on Real GDP of Major Countries & Regions | Chart 5



Source: OECD, The White House, USBIS, USCBP, and other sources; compiled by DIR.
Note: The impact of the decline in exports to the US in each country and region due to the implementation of tariffs (including the impact of the decline in exports of intermediate goods to third countries and spillover effects) was estimated using the OECD's International Input-Output Table (2019 edition). For tariff measures whose details have already been announced, we referred to the published data of the US government, and for tariff measures whose details have not been announced, we extracted the items to which the reciprocal tariff does not apply. In the case of discrepancies between the OECD's International Input-Output Table and the range of taxable items, we have adjusted the estimates using the share of each country's exports to the US by product category.

Zero consumption tax on foods: Not very cost-effective, and policy effect has nearly uniform benefit

4.0 tril yen tax cut will have only a 0.3 tril yen effect in stimulating consumption

Shifting our gaze back to the domestic situation, opposition parties such as The Constitutional Democratic Party of Japan (CDP) and the Japan Innovation Party (Nippon Ishin) are proposing a lower consumption tax rate as a response to the Trump tariffs and high prices.

The main source of high prices is food, and a reduction in the consumption tax rate on food products has the advantage of being direct and making the burden reduction more noticeable. However, as discussed below, the amount of the tax cut is larger for higher-income households, making it less cost-effective. Even if implemented as a time-limited measure, there is a possibility of repeated extensions, as in the case of measures against high energy prices, and the disadvantages are greater, such as the significant decline in the function of consumption tax as a source of funding for social security.

Chart 6 compares the amount of burden reduction by annual household income bracket for the case where the consumption tax rate on food items subject to the reduced tax rate is reduced to zero percent (zero consumption tax on foods) and the case where all citizens receive a uniform benefit of 30,000 yen per person (uniform 30,000 yen benefit).

The scale of the tax cut, estimated from GDP statistics (Cabinet Office) and Family Income and Expenditure Survey (Ministry of Internal Affairs and Communications), is around 4.0 tril yen, or 72,000 yen per household. This is close to the size of the 30,000 yen uniform benefit (total benefit amount: 3.6 tril yen, 65,000 yen per household), and in both measures, the burden reduction is larger for higher-income households (Chart 6, right). Although the degree of burden reduction relative to annual household income is greater for lower-income households in the case of the “zero consumption tax on foods” approach, the amount of burden reduction for households in the top 20% of annual income (income bracket V in the chart) is more than twice that of households in the bottom 20% (income bracket I).

Effects of "Zero Consumption Tax on Foods" Policy (left) and Amount of Burden Reduction from Consumption Tax Cut and Flat 30,000 Yen Benefit by Household Income Bracket (right) Chart 6

◆Effects of "Zero Consumption Tax on Foods" Policy
(Excludes Alcoholic Drinks and Eating Out)

＜ Amount of Tax Reduction ＞

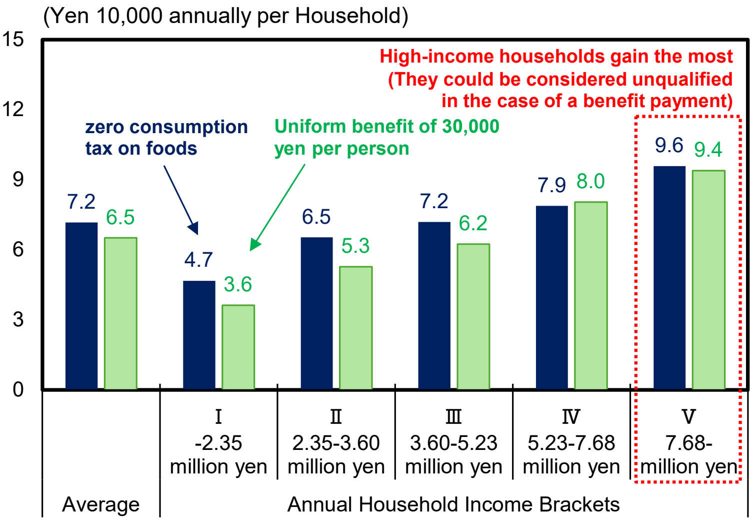
- Amount of tax cut estimated from GDP statistics etc. is **around 4.0 tril yen**
- Exceeds **uniform benefit of 30,000 yen per person** (3.6 tril yen). Cash payment of **benefit can be limited to low income households** but **the amount of the consumption tax cut is larger for high-income households (see Chart at right)**.

＜ Economic Effect ＞

- Domestic research on benefit payments, tax cuts and use of coupons finds that the marginal propensity to consume would be **around 0.1-0.3**.
- From a macro point of view, household marginal propensity to consume may have **declined since the COVID-19 pandemic**.
- Food products are a daily necessity, and the price elasticity of demand is low.

→Assuming marginal propensity to consume at 0.1, **its upward pressure on GDP is** only **around 0.3 tril yen (around tax cut amount of 4.0 tril yen)**.

⇒**The policy is not cost effective. If the purpose is to provide economic support, a policy providing benefits to a more selective demography** would be preferable. Even if there is a time limit on the measure, it **could end up being extended repeatedly** like the measures against high energy costs.



Source: Cabinet Office, Ministry of Internal Affairs and Communications, Ministry of Health, Labour and Welfare; compiled by DIR.
Note: The left side of the chart shows the amount of tax reduction for "zero consumption tax on foods" after reflecting the price increase in 2024 in consumption amount for foods in 2023 in the GDP statistics. The effect of boosting GDP was calculated using the DIR short-term macro model. The right side of the chart is based on total households in 2024. Corrected for the discrepancy between macro food expenditures (excluding alcoholic beverages and eating out, 2023) calculated from household consumption in the Family Income and Expenditure Survey and the number of households in the Comprehensive Survey of Living Conditions and consumption amount for foods in the GDP statistics (adjusted by multiplying household consumption in each income bracket by 1.49).

While consumption tax cuts benefit all households, they cannot be targeted to specific income groups. As a result, a large amount of fiscal expenditure will be allocated to households that have little need for support. With payment of cash benefits, it is possible to exclude certain categories (households) above a certain income level or to make the benefits taxable.

The economic effects of zero consumption tax on foods are expected to be limited. As pointed out by Yamaguchi and Kanda (2025)[7], (1) prior domestic studies on benefits, tax cuts, and coupons indicate that the marginal propensity to consume (the ratio of increased income going to consumption) is around 0.1-0.3, (2) households' marginal propensity to consume from a macro perspective has declined since the COVID-19 pandemic, and (3) food products are a daily necessity with low price elasticity of demand. The economic effect of zero consumption tax on foods is estimated to be around 0.3 tril yen, which is extremely small for a tax cut of 4.0 tril yen. If the objective is to support people's daily needs, it would be more desirable to provide benefits to those who are in need by targeting that income group.

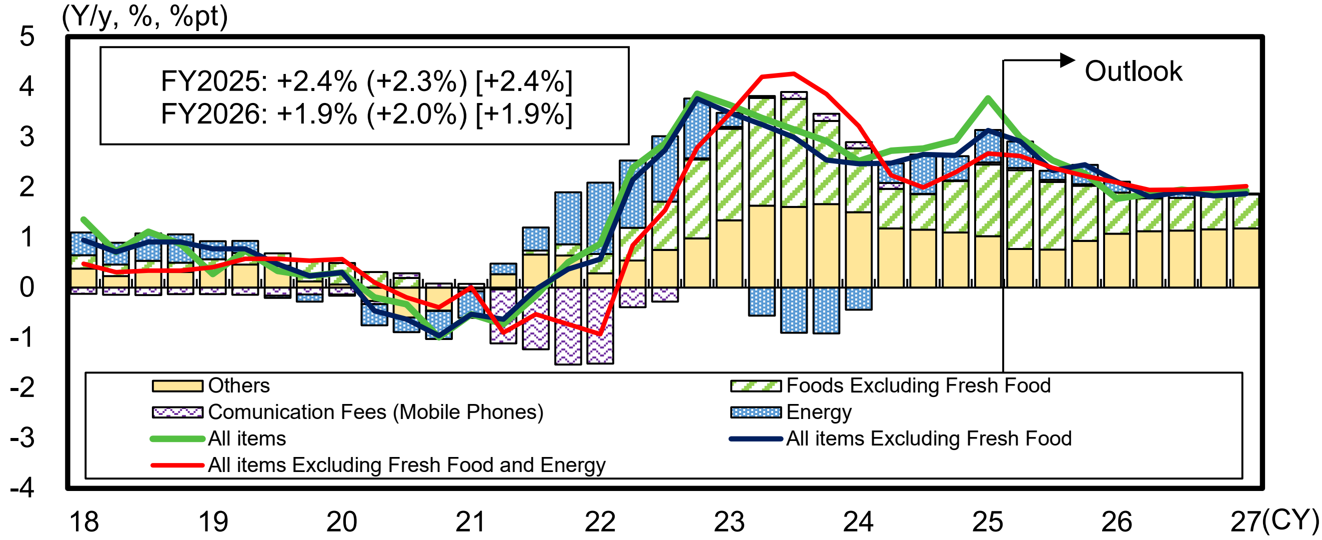
3. Outlook for Prices and Monetary Policy

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

On an all items basis, CPI is projected to increase by +2.4% y/y in FY2025, with +1.9% expected in FY2026. On an all items basis, less fresh food, core CPI is projected to increase by +2.4% y/y in FY2025, and +1.9% in FY2026 (Chart 7). Meanwhile, on an all items basis, less fresh food and energy (new core-core CPI), the forecast is +2.3% in FY2025 and +2.0% in FY2026.

[7] DIR report, dated 16 April 2025, by Akane Yamaguchi and Keiji Kanda, "Household Support Measures Under Discussion in Light of Trump Tariffs: Which is More Desirable – Cash, Tax Cuts, or Points?" (Japanese only)

Outlook for Core CPI (Figures in Parentheses are Excluding Fresh Food and Energy, Square Brackets Indicate Overall Figures) Chart 7



Source: Ministry of Internal Affairs and Communications; compiled by DIR.
Note: Price outlook assuming resource prices and exchange rates at the time of this writing. Assumes phased implementation of a 10 yen/liter gasoline subsidy (5 yen/liter for kerosene) from May 22 to the end of September.

In both cases, price hikes are expected to slow through FY2026, but on the policy front, free high school tuition and the government's measures against high energy prices will work to push prices down. Starting in April 2025, income restrictions on tuition support grants will be lifted, effectively making public high school tuition free for all households. Furthermore, from April 2026, the upper limit of the grant amount will be raised, effectively making tuition fees for private high schools free. In the energy sector, fixed subsidies for gasoline and kerosene began in May 2025. In addition, the government plans to subsidize electricity and gas bills for July through September, although specific details have not been disclosed at the time of this writing.

The pace of growth in food prices is expected to slow as the surge in rice prices gradually settles down. However, the pace of the slowdown in food prices (including food service), excluding fresh food, will remain moderate, as the sharp increases in rice prices and some vegetable prices up to the present will spread to prices of other food products, food service, and other related items. On the other hand, the structural issue of a worsening labor shortage is expected to continue prompting companies to raise wages. The accompanying increase in labor costs will continue to be passed on to selling prices. Supported by these developments, underlying prices are expected to remain stable at around 2% y/y.

If the Trump tariffs continue as assumed in our main scenario, the impact on Japan's real GDP will be relatively small and the effect on the CPI growth rate will be limited. However, if negotiations with the US by large economies such as China and the EU break down and retaliatory tariffs are implemented by both sides, the domestic supply-demand balance will deteriorate and wage increases will lose momentum through a drop in overseas demand, which will likely lead to a downward swing in prices in the future.

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

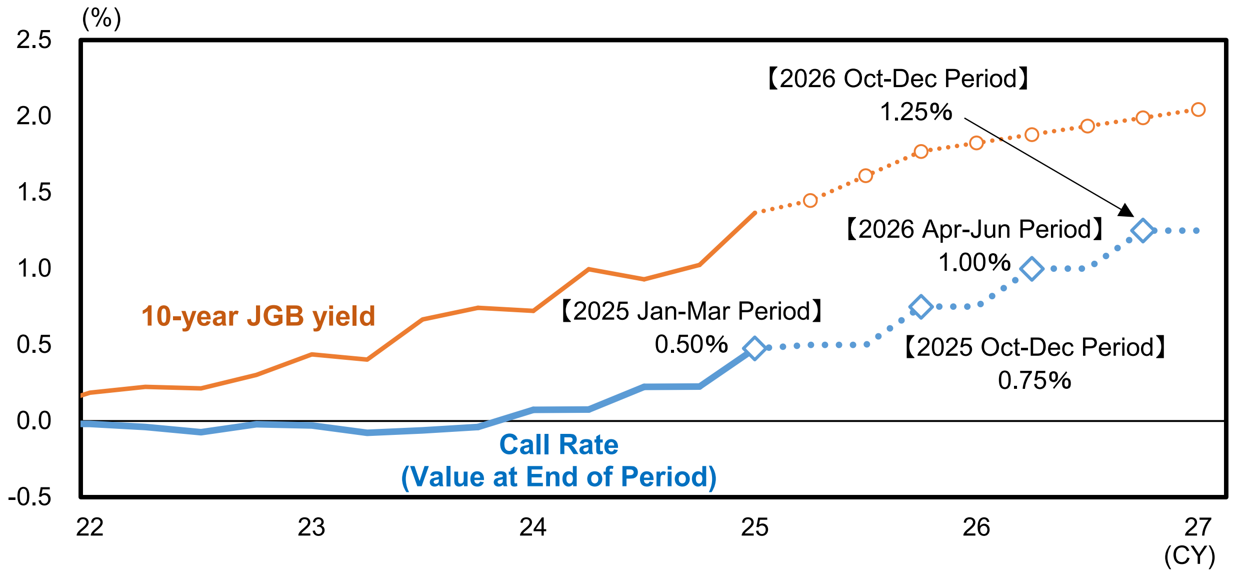
Considering the uncertainty surrounding the Trump tariffs, we have changed our outlook for the timing of the BOJ's next interest rate hike. According to our main scenario, the short-term interest rate is expected to be raised to 0.75% in the Oct-Dec period of 2025 (in October on a monthly basis), followed by additional rate hikes of 0.25%pt every six months or so (reaching 1.25% by the Jan-Mar period of 2027, the end of the forecast period, Chart 8).

As mentioned above, from the perspective of domestic wage and price trends, there is strong pressure for interest rate hikes. Additionally, while there remains significant uncertainty regarding the adverse effects of the Trump tariffs on prices and the economy, if negotiations with the US progress during the 90-day suspension period for additional tariffs, as assumed in the main scenario, the likelihood of avoiding a significant increase in mutual tariffs will increase, leading to a gradual decline in uncertainty surrounding the global economy. Based on these assumptions, we expect that the BOJ will have the conditions in place to raise interest rates by October 2025.

Japan's natural interest rate is estimated to be around zero percent at present, but we expect it to turn slightly negative in line with the decline in potential growth. We expect the inflation rate to remain at around +2% y/y, and the terminal rate (the final policy interest rate) consistent with this will be 1.75%. The Trump tariffs will have a negative impact on demand in Japan, delaying the timing of reaching the terminal rate, but the level will remain unchanged.

We expect the long-term interest rate to rise to around 2.1% toward the end of the forecast period (Chart 8). The long-term interest rate temporarily fell sharply on expectations that the timing of interest rate hikes would be postponed due to heightened uncertainty in the global economy. However, as mentioned above, we believe that conditions will be in place for the BOJ to raise interest rates in the fall of 2025. Reflecting these developments, the long-term interest rate is likely to rise at a faster pace toward the second half of 2025.

Outlook for Long and Short-Term Interest Rates in Japan **Chart 8**



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.

Japan’s Economic Outlook No. 225 (May 22, 2025) Chart 9

		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	557.3	558.7	562.0	561.1	561.4	563.1	564.5	565.7	567.0	568.2	569.5	570.8	559.8	563.8	568.9
	Q/q %	0.9	0.2	0.6	−0.2	0.1	0.3	0.2	0.2	0.2	0.2	0.2	0.2			
	Q/q %; annualized	3.8	1.0	2.4	−0.7	0.2	1.3	0.9	0.9	0.9	0.9	0.9	0.9			
	Y/y %	−0.6	0.8	1.3	1.7	0.8	0.8	0.5	0.8	1.0	0.9	0.9	0.9	0.8	0.7	0.9
														(0.2)	(0.9)	(0.9)
Private Consumption	Q/q %	0.8	0.7	0.1	0.0	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.8	1.0	0.9
Private Residential Investment	Q/q %	1.2	0.7	−0.2	1.2	0.6	−1.2	−0.6	−0.6	−0.7	−0.7	−0.8	−0.8	−1.0	0.2	−2.8
Private Non-Resi. Investment	Q/q %	1.4	0.1	0.8	1.4	−0.5	0.3	0.4	0.3	0.4	0.4	0.4	0.4	2.6	1.5	1.5
Government Consumption	Q/q %	0.9	0.1	0.3	0.0	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	−0.7	−0.4	0.0	0.2	0.2	0.1	0.1	0.0	0.0	0.0	1.4	−0.6	0.4
Exports	Q/q %	1.5	1.2	1.7	−0.6	0.2	0.2	0.3	0.3	0.4	0.4	0.5	0.6	1.7	1.3	1.6
Imports	Q/q %	2.7	2.2	−1.4	2.9	−1.0	−0.2	0.4	0.4	0.5	0.5	0.5	0.5	3.4	1.1	1.7
Nominal GDP	Q/q %; annualized	10.0	2.2	4.8	3.1	2.5	3.1	2.4	2.3	2.3	2.3	2.3	2.3	3.7	3.0	2.4
GDP deflator	Y/y	3.1	2.4	2.9	3.3	2.4	2.6	2.3	1.7	1.5	1.4	1.4	1.4	2.9	2.2	1.4
Industrial production	Q/q	2.1	0.3	0.4	−0.3	−0.2	0.5	0.4	0.4	0.3	0.4	0.4	0.5	−1.4	0.5	1.5
Core CPI	Y/y	2.5	2.7	2.6	3.1	2.9	2.3	2.4	2.1	1.8	1.9	1.8	1.9	2.7	2.4	1.9
Unemployment rate	%	2.6	2.5	2.5	2.5	2.4	2.4	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	0.23	0.48	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	0.48	0.75	1.25
Current account balance	Y tril; annualized	1.00	0.93	1.03	1.37	1.45	1.61	1.77	1.83	1.88	1.94	1.99	2.05	1.08	1.66	1.96
Major assumptions																
Crude oil price (WTI futures)	$/bbl	80.7	75.3	70.3	71.4	62.3	62.6	62.6	62.6	62.6	62.6	62.6	62.6	74.4	62.5	62.6
Exchange rate	Yen/$	155.8	149.1	152.4	152.4	144.7	144.5	144.5	144.5	144.5	144.5	144.5	144.5	152.4	144.5	144.5

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. Assumes phased implementation of a 10 yen/liter gasoline subsidy (5 yen/liter for kerosene) from May 22 to the end of September.