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Japan's Economy: Monthly Outlook (Aug 2025)

Economic Outlook Revised: Trump tariffs require continued caution

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Summary

- In light of the announcement of the Apr-Jun 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 +0.8% in FY2026. (On a calendar year basis, we expect +1.1% in 2025 and +0.7% in 2026).

- Although 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 as a result of the spring labor negotiations, and a decline in the rate of growth in prices. Due to wage hikes, the price pass-through cycle and other factors, we expect the growth rate trend in CPI to be 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. It is necessary to be cautious regarding the impact of the Trump tariffs on domestic and overseas economic activity, as well as rising crude oil prices due to tensions in the Middle East.

- We assume that the Bank of Japan (BOJ) will raise the short-term interest rate to 0.75% in the Oct-Dec 2025 period 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. Real interest rates are expected to remain negative throughout the forecast period, and monetary conditions are likely to remain accommodative for the time being.

1. Moderate Recovery Expected, but We Remain Wary of Trump tariffs

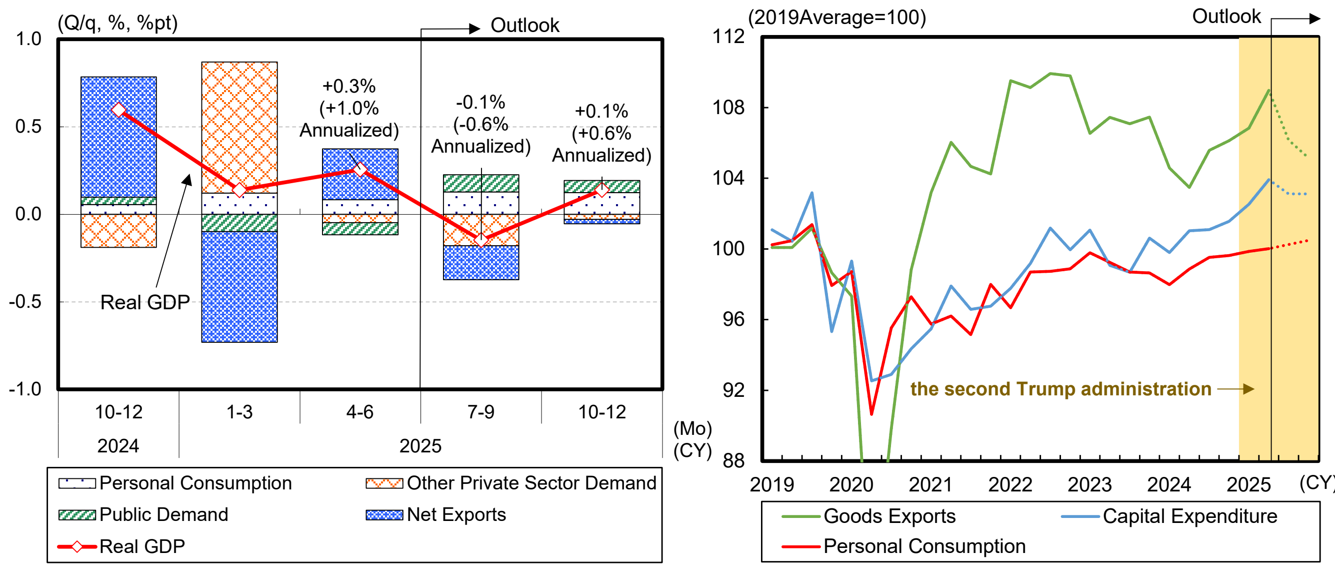
Real GDP may shift into the negative in the Jul-Sep 2025 period after five consecutive quarters of growth

The real GDP growth rate for Apr-Jun 2025 (1st preliminary est) was up by +1.0% q/q annualized (+0.3% q/q), registering the fifth consecutive quarter of growth (Chart 1, left)[1]. The Trump administration imposed some reciprocal tariffs in April, imposing a 25% additional tariff on automobiles imported into the US, significantly strengthening its high tariff policy (Trump tariffs). As a result, the average tariff rate on Japanese exports to the US, which stood at 1.9% in March, rose to 15.3% in June (according to calculations by DIR based on US Census Bureau statistics). However, the pass-through of these tariffs to US retail prices was contained, leading to a stronger increase in goods exports during the Apr-Jun period[2], while capital investment also remained robust (Chart 1, right).

Looking at performance by demand component (Chart 1, left), in the area of private sector demand, capital expenditure and housing investment achieved growth, but private sector inventories was responsible for pushing down the GDP growth rate by 0.3%pts. As for public sector demand, government consumption grew slightly, while public investment declined. Meanwhile, in the area of overseas demand, both exports and imports grew, with exports exceeding imports in growth, thereby pushing up the real GDP growth rate.

Real employee compensation (real figure calculated using the household final consumption expenditure deflator) was up by +1.0% in comparison to the previous period, growing for the first time in two quarters. According to the Labour Force Survey (Ministry of Internal Affairs and Communications), the number of employees increased by +0.1% q/q, while real employee compensation per capita (calculated by dividing real employee compensation by the number of employees) increased by +0.9% q/q (the fifth consecutive quarter of growth in y/y terms, Chart 3). In addition to the continuation of wage increases as a result of the spring labor negotiations in 2025, summer bonuses were also at a high level.

Real GDP Growth Rate Results & Outlook (Left); Trends in Export of Goods, Capital Expenditure, and Personal Consumption (Right) **Chart 1**



Source: Cabinet Office; compiled by DIR.
Notes: Figures are seasonally adjusted. Outlook produced by DIR.

[1] See the DIR report by Keiji Kanda and Munehisa Tamura dated 15 August 2025, *Apr-Jun 2025 1st Preliminary GDP Estimate* (Japanese only).
[2] For details, refer to the DIR report of 5 August 2025, *Japanese Economy: Monthly Outlook: (Jun 2025)*.

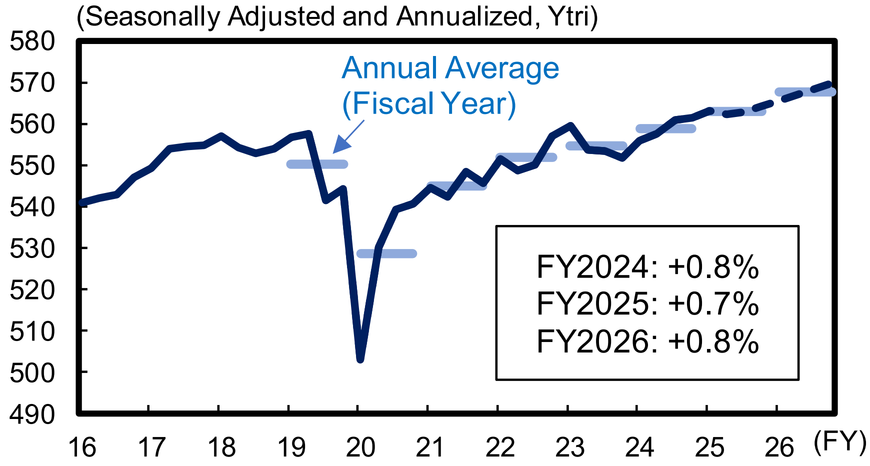
We expect Japan’s Jul-Sep 2025 period real GDP growth rate to decline by -0.6% q/q annualized (-0.1% q/q) (Chart 1 left). Though the level of uncertainty is great, the effects of the Trump tariffs are expected to gradually appear, and this is expected to bring weakness centering on the export of goods. On the other hand, personal consumption continues in a moderate recovery with continued wage hikes and a slowdown in the growth rate of prices, and is expected to provide underlying support for the economy, with expectations of a shift back into positive terrain for the real GDP growth rate in the Oct-Dec period of 2025.

Summary of the overseas economic outlook and assumptions regarding Trump tariffs

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 August 21 is provided by our in-house experts on the overseas economy.

Outlook for Japan’s Real GDP and Assumptions Regarding Overseas Economies

Chart 2



US, Eurozone & China Real GDP Growth Rate

US	2024: +2.8% 2025: +1.7% 2026: +1.7%
Eurozone	2024: +0.9% 2025: +1.2% 2026: +1.2%
China	2024: +5.0% 2025: +4.9% 2026: +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 estimated by DIR. Outlooks for the US, Eurozone and China are based on predictions by DIR’s in-house experts.

We expect growth in real GDP in 2025 to be up by +1.7% y/y for the US, +1.2% for the Eurozone, and +4.9% for China. Our outlooks for both the US and the Chinese economies were revised upwards by 0.1%pts in comparison to our report of June 9, 2025 (*Japan’s Economic Outlook No. 225 Update* (Japanese only), hereafter “our previous outlook”), while our outlook for the Eurozone economy remains the same as before, (our outlook for growth rates in 2026 remains the same for the US, Eurozone and China).

Major countries and regions, including Japan, reached agreements with the US in tariff negotiations by early August 2025, but uncertainty surrounding Trump tariffs remains high. Our main scenario assumes that the current tariff rates will remain in effect, but it cannot be ruled out that the US may withdraw from the agreement and raise tariff rates or introduce new measures such as sector-specific tariffs. In addition, negotiations between the US and China, as well as other countries, are ongoing, and President Trump has indicated his intention to impose secondary tariffs on China, which is a major importer of Russian crude oil. The economic impact of Trump's tariffs will be quantitatively examined in Chart 5 in the next chapter.

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 +0.8% in FY2026 (Chart 2, +1.1% in 2025 and +0.7% in 2026 on a calendar year basis).

The outlook for the FY2025 growth rate was revised downwards slightly by 0.04%pt. 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 0.2%pt. This reflects the delay in recovery of personal consumption against the backdrop of soaring food prices and growing uncertainty about the future, as well as steady imports. On the other hand, the outlook for the Jul-Sep period and beyond has been raised in response to five consecutive quarters of growth in capital investment through the Apr-Jun period of 2025[3].

We have revised our outlook for FY2026 downwards by 0.1%pt from the previous one. The main reason is carryover of -0.1%pt. Our view remains unchanged that while Trump's tariffs will be maintained, exerting downward pressure primarily on exports, a gradual economic recovery will continue through factors such as a rebound in personal consumption.

Looking at performance by major demand components, we expect personal consumption to continue moderate growth. The high level of wage hikes as a result of the spring labor negotiations is expected to continue, and 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), as well as increases in basic deductions (with refunds for CY2025 to be made through year-end adjustments, etc.). The y/y change in real wages per employee is projected to remain positive throughout the forecast period, with an increase of around 1% by the end of FY2026, similar to past labor productivity growth rate (Chart 3, left). Additionally, high levels of household savings[4] are expected to continue supporting personal consumption.

Looking back on the spring labor negotiations of 2025, it appears that most corporations aggressively raised wages even more so than the previous year. Especially prominent in that trend were small and medium-sized enterprises and micro enterprises. According to statistics compiled by the Japan Business Federation (Keidanren)[5], the rate of wage hikes was higher for small and medium-sized enterprises than for large enterprises, while statistics compiled by the Japanese Trade Union Confederation (RENGO)[6] found that companies with 99 employees or less showed a higher rate of wage hikes than the overall figure. The Japan Chamber of Commerce and Industry (JCCI) and the Tokyo Chamber of Commerce and Industry (TCCI), which mainly survey small and medium-sized enterprises and micro enterprises, as well as surveys run by the Ministry of Health, Labour and Welfare[7], also found that, overall, wage hikes had clearly accelerated (Chart 3, right).

Wage hikes may have risen more in regional areas than in urban areas. Looking at the rate of wage hikes by region shown on the website of each of the RENGO Locals, the regional division of the Japanese Trade Union Confederation, and calculate wage hike rates excluding urban areas[8], the increase in wage

[3] In addition, public investment for FY2025 has been revised upwards by a relatively large amount in this outlook, but this is largely due to the revision of the Ministry of Land, Infrastructure, Transport and Tourism's "Quick Estimate of Construction Investment" retroactively, which resulted in fairly large carryover of +0.8pt.

[4] According to the Bank of Japan's "Flow of Funds Accounts Statistics," household financial assets totaled 2,195 tril yen at the end of March 2025. This is an increase of 143 tril yen from the end of December 2021, just before the decline in real wages, and an increase of 110 tril yen on a net basis, excluding liabilities.

[5] See "2025 Spring Labor-Management Negotiations: Settlement Results by Major Industry (Weighted Average)" (August 6, 2025) (Japanese only) and "2025 Spring Labor-Management Negotiations: Responses by Small and Medium-Sized Enterprises [Including Acceptance and Settlement] (Weighted Average)" (June 20, 2025) (Japanese only).

[6] Refer to "Wage Increases Exceeded Previous Year! - the 7th (Final) Round of Results of the 2025 Spring Labor Negotiations" (July 3, 2025), the Japanese Trade Union Confederation (Rengo) (Japanese only).

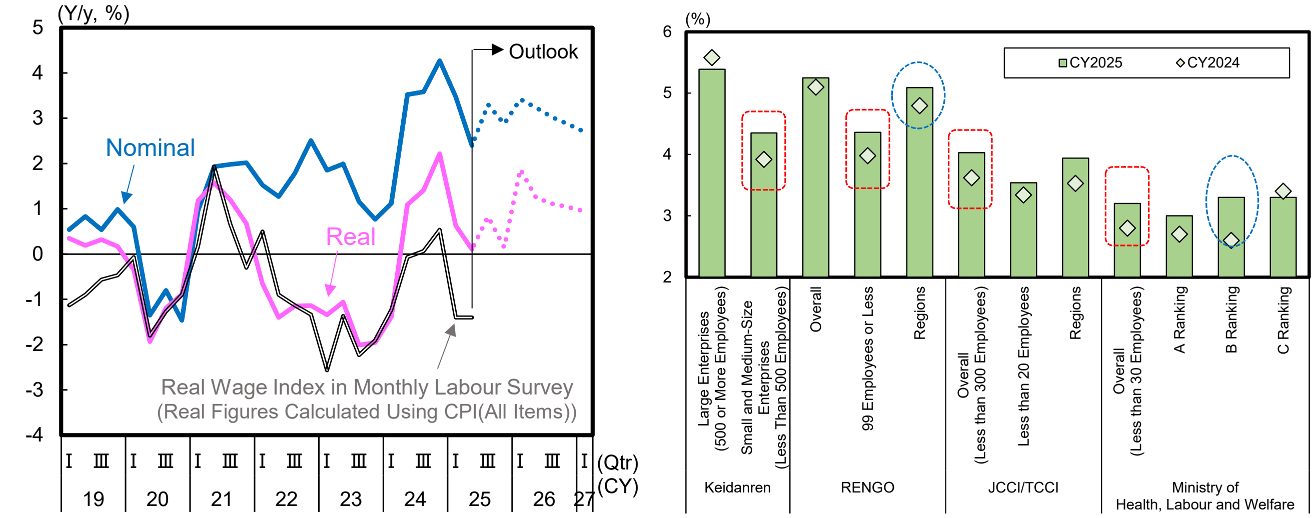
[7] Refer to the "Survey on Wage Revisions of Small and Medium-sized Enterprises" conducted by the Japan Chamber of Commerce and Industry and the Tokyo Chamber of Commerce and Industry (June 4, 2025) (Japanese only) and the "Survey on Wage Revision Status" conducted by the Ministry of Health, Labour and Welfare (Japanese only).

[8] Applies to Saitama, Chiba, Tokyo, Kanagawa, Gifu, Aichi, Mie, Kyoto, Osaka, Hyogo, and Nara. Note that Nagano, Kagoshima, and Okinawa, where wage increase rates are not disclosed and cannot be confirmed through media reports, have been excluded from the calculation.

hike rates is large than the overall figure. In addition, according to a survey by the Ministry of Health, Labour and Welfare, wage increases accelerated in B-ranked areas compared to A-ranked urban areas, with C-ranked areas showing the highest growth rate[9].

In FY2025, this widespread wage increase is expected to contribute to improved income conditions. In FY2026, high wage increases are expected to continue against a backdrop of continued price rises and economic recovery, as well as chronic labor shortages.

Outlook for Employee Compensation Per Capita (Left), Wage Hike Rates According to Various Statistics (Right) **Chart 3**



Source: Ministry of Health, Labour and Welfare, Ministry of Internal Affairs and Communications, Cabinet Office, Japan Business Federation, Japan Chamber of Commerce and Industry / Tokyo Chamber of Commerce and Industry, Japanese Trade Union Confederation, RENGO Locals Data, Media Reports; compiled by DIR.

Note: Figures for employee compensation per capita (real figures calculated based on household final consumption expenditure deflator) on the left side of the chart are seasonally adjusted and on a y/y basis. Dashed lines are DIR estimates. In the chart on the right, Keidanren is the Japan Business Federation, JCCI/TCCI is the Japan Chamber of Commerce and Industry and the Tokyo Chamber of Commerce and Industry, and figures are statistics compiled by each of these organizations. The figure under “Overall” for JCCI/TCCI is 97.8% accounted for by companies with fewer than 300 employees. Figures shown under “Overall” and 99 Employees or Less for RENGO were compiled by the Japanese Trade Union Confederation (RENGO), while figures under Regions are the average rates of wage hikes by region shown on the websites of RENGO Locals (excluding urban areas of Saitama, Chiba, Tokyo, Kanagawa, Gifu, Aichi, Mie, Kyoto, Osaka, Hyogo, Nara, and regions for which wage hike rates have not been publicized and have not appeared in news reports, including Nagano, Kagoshima, and Okinawa). Ministry of Health, Labour and Welfare figures are from the ministry’s “Survey on Wage Revision Status,” which uses figures for wage hike rates for general workers who were employed in June of both the current year and the previous year.

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. Moreover, on the domestic front as well, construction investment could be sluggish due to delays in construction schedules caused by labor shortages.

Government consumption is expected to remain steady. In addition to an increase in medical and nursing care benefits due to the aging population, active wage increases by private companies are also expected to be reflected in public sector wages, which will serve as a driving factor. In FY2025, growth is expected

[9] The Central Minimum Wages Council has classified the 47 prefectures into three categories—A (6 prefectures), B (28 prefectures), and C (13 prefectures)—based on economic conditions, and has presented guidelines for minimum wage increases for each category. The “Wage Revision Survey,” the results of which are also submitted to the Council, organizes and publishes data based on these categories.

to be modest (+0.3% y/y) partly reflecting a reactionary decline from the previous year's steady growth, but it is likely to accelerate again in FY2026 (+1.3%).

As for exports, goods exports are expected to be up by +1.0% y/y in FY2025, but when carryover is excluded, it appears to be at a standstill at -0.3%. In addition to the negative pressure on exports to the US as the tendency of passing on increases in tariffs to sales prices spreads, the recovery of the silicon cycle is expected to take a breather during the second half of the fiscal year 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[10], but business services, etc. are expected to provide underlying support.

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

While an improved income environment and other factors bring underlying support to Japan’s economy, Trump tariffs and the high price of crude oil require caution

As in our previous outlook, 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. The consumer price index (CPI) rose by more than 3% y/y recently, but the rate of increase slowed to around 2% due to a slowdown in food price rises. The BOJ is expected to continue raising interest rates 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,” “suppression of economic activity due to intensification of US-China conflict and strengthening of economic security measures,” “rising crude oil prices due to growing tensions in the Middle East,” and “rapid appreciation of the Japanese yen.”

Below, of these downside risks, we examine the “downturn in US economy due to Trump administration policies,” and “rising crude oil prices due to growing tensions in the Middle East.”

“Downturn in US Economy Due to Trump administration policies” – If additional tariffs on China are raised to 80%, Japan's GDP will decline by 0.3%.

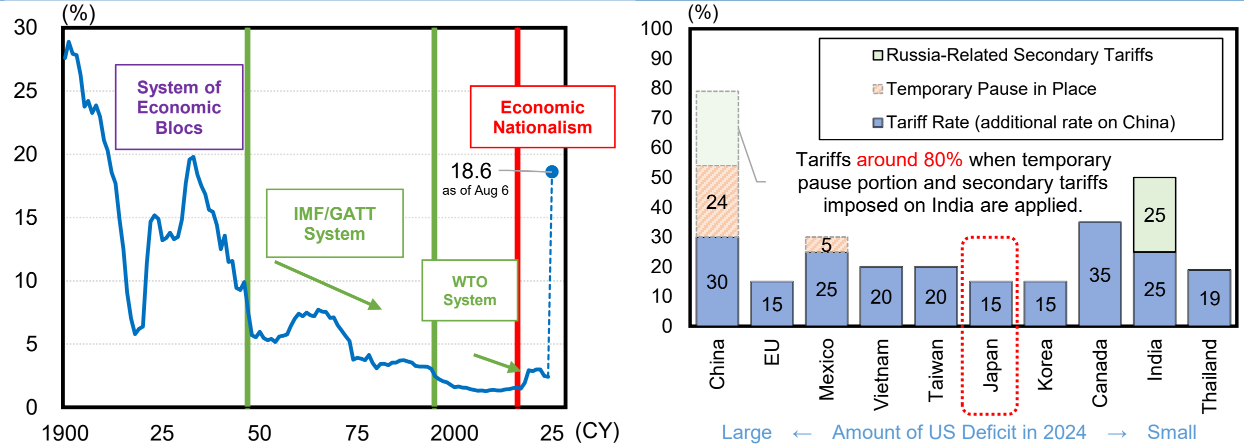
The average US tariff rate is at its highest level since 1933, and many of Japan's exports to the US are subject to a 15% tariff rate.

As has been mentioned previously in this report, major countries and regions, including Japan, reached agreements with the US in tariff negotiations by early August 2025. According to the Budget Lab at Yale, the average tariff rate on US imports reflecting these changes is 18.6%, the highest since 1933 when a system of economic blocs was in place (Chart 4, left).

[10] The number of foreign visitors to Japan (Japan National Tourism Organization) is expected to increase from 36.87 million in 2024 to around 43 million in 2025 and around 45 million in 2026 (real inbound consumption will increase from 6.8 tril yen in 2024 to around 7.6 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.

Average US Tariff Rates (left), Tariff Rates for Top 10 Countries & Regions in Terms of US Trade Deficit (right)

Chart 4



Source: The Budget Lab at Yale, the White House, News Reports; Compiled by DIR.
Notes: The average effective tariff rate in 2025 is an estimate by The Budget Lab at Yale, based on the assumption that consumers and businesses will not change their product choices in response to tariffs.

Excluding certain items such as semiconductors, the tariff rate imposed on Japanese exports to the US, including automobiles and their parts, will be 15% (Chart 4, right). Although the 25% increase President Trump advocated on his social media on July 7 was avoided, as mentioned earlier, the average tariff rate on Japanese exports to the US was 15.3% in June. Even after the Japan-US agreement, tariff rates remain high, meaning the challenging export environment will persist. However, the tariff rates agreed upon by Japan's main export competitors in the US market—Germany and South Korea—are at the same level as Japan's, meaning Japan is not at a disadvantage in terms of price competition. Since China's tariff rates are higher than those of Japan, South Korea, and Germany, there is potential for Japan to gain alternative demand (reaping the so-called “fisherman's benefit”) going forward.

As President Trump often asserts, if production is carried out within the US tariffs can be avoided. However, increased costs such as labor expenses can be expected. If we set the nominal compensation per employee in the US manufacturing sector for a recent year, 2021, at 100.0, Germany stands at 78.7, South Korea at 63.4, and Japan at 59.8. All these countries fall significantly below US wage levels (calculated in US dollars, based on OECD statistics, and estimated by DIR). On the other hand, Mexican and Canadian exports to the US that do not comply with the US-Mexico-Canada Agreement (USMCA) face tariffs of 25-35%. Consequently, products utilizing the supply chains established among the three North American countries are also expected to incur certain cost increases.

Currently, businesses are absorbing most of the increased tariff costs, and the pass-through to US retail prices appears to be limited. However, if price pass-through accelerates, it will likely depress US personal consumption through reduced household purchasing power, leading to a deterioration in the US economy and a decline in Japanese exports.

Impact of Trump tariffs on Japan's real GDP estimated at -1.0% to -0.9%, with caution advised regarding risk of additional tariffs on China

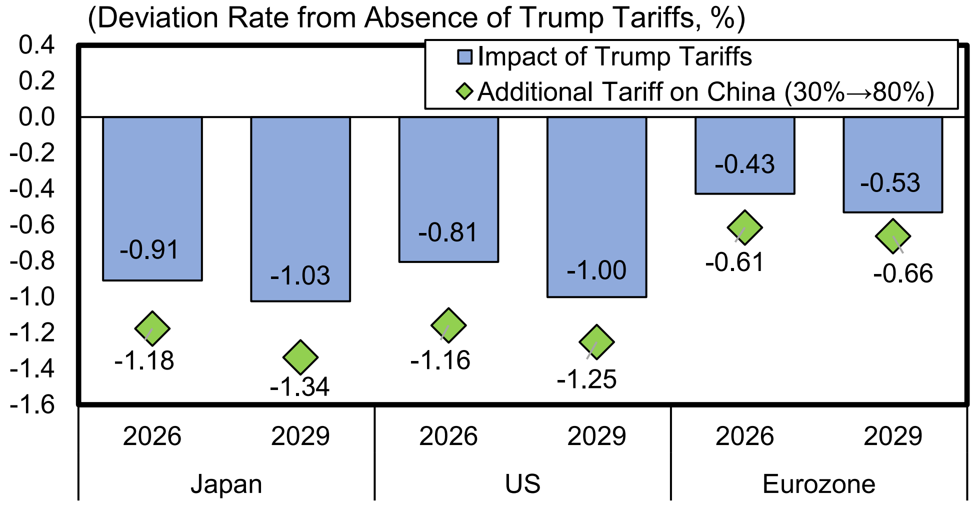
As was mentioned previously in this report, according to our main scenario, we assume that tariff rates will remain at recent levels, and expect Japan’s economy to continue to grow at a moderate pace (Chart 2).

Chart 5 shows the impact of Trump tariffs (country/region-specific tariffs[11]) on the real GDP of Japan, the US, and Eurozone[12]. Compared to a scenario without Trump tariffs, real GDP in 2026 (2029) is estimated to be reduced by 0.9% (1.0%) in Japan, 0.8% (1.0%) in the US, and 0.4% (0.5%) in the Eurozone.

The impact on Japan could be greater than that on the Eurozone, comparable to the impact on its epicenter, the US. One reason the Japanese economy could suffer a significant downturn is its structural vulnerability to declines in overseas demand. Specifically, when uncertainty in overseas economies increases, the yen—regarded as a safe-haven currency—tends to be bought, leading to yen appreciation. This makes exports particularly susceptible to sharp declines through two channels: reduced overseas demand and a stronger currency.

Furthermore, a limited margin for monetary policy is another characteristic of the Japanese economy. Unlike central banks in major countries and regions that have significantly raised policy rates to counter high inflation since the pandemic, the BOJ—which began normalizing monetary policy in March 2024—has only about 0.5% room to cut policy rates. Should a major negative demand shock occur, such as a sharp downturn in overseas economies, rate cuts alone would likely prove insufficient.
Caution is warranted regarding the risk that the additional tariffs imposed by the second Trump administration on China could rise to around 80% in total. This would occur if the currently suspended 24% tariff and a secondary tariff equivalent to India's were added to the existing 30% tariff. In this scenario, estimates suggest that the downward pressure on Japan's real GDP caused by Trump tariffs would increase by approximately 0.3%pt (Chart 5).

Impact of Trump Tariffs on Real GDP in Japan, US, and Europe **Chart 5**



Source: Cabinet Office, FRB, USITC, Haver Analytics, and various other statistical sources; compiled by DIR.
Note: The chart focuses on country-specific tariffs, with estimates based on the assumption that tariff rates will remain at recent levels.

[11] Our previous outlook estimated the impact of Trump tariffs including sector-specific tariffs. Subsequently, as negotiations progressed between the US and various countries/regions, and exemptions for sector-specific tariffs expanded, it became difficult to independently estimate country-specific and sector-specific tariffs. Therefore, this time only the estimated results for country/region-specific tariffs are shown.
[12] For Japanese exports to the US, items such as semiconductors, pharmaceuticals, and copper may be subject to individual tariff measures as excluded items under the Japan-US agreement. For the economic impact of these measures, refer to the DIR report dated 15 April 2025 by Koki Akimoto and Shotaro Kugo, "Impact of U.S. Tariff Hikes on Semiconductors on the Japanese and Global Economies" (Japanese only).

"Rising crude oil prices due to growing Tensions in the Middle East"

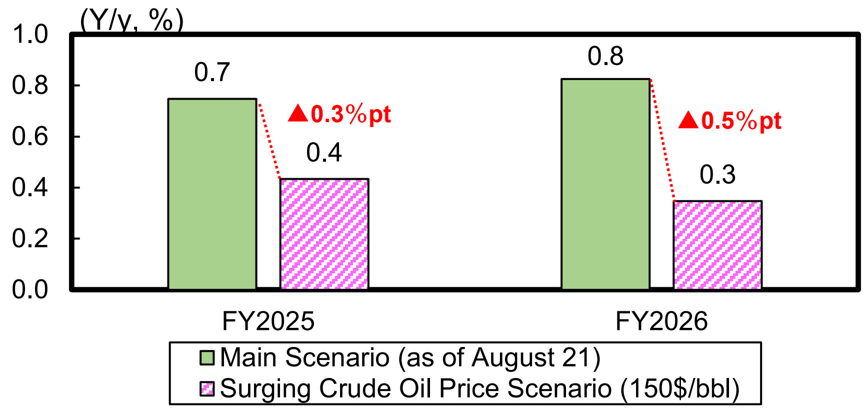
If the price of crude oil hits $150/bbl, the outlook for Japan's Real GDP growth rate in FY2025 will fall by 0.3%pt

Geopolitical risks rapidly escalated due to the military conflict between Israel and Iran in June 2025 and the US attack on Iranian nuclear facilities. Crude oil prices (WTI), which had been hovering near $60/bbl in late May, temporarily rose to around $75.

Although Israel and Iran are currently in a ceasefire, the possibility of renewed tensions in the Middle East cannot be ruled out. In such a scenario, the sharp rise in crude oil prices is a particular concern for the Japanese economy. Should the Strait of Hormuz, through which approximately 20% of the world's oil supply passes, be blocked, the pace of crude oil price increases is expected to accelerate significantly. Soaring crude oil prices would push up domestic final goods prices through increased Japanese energy import costs and higher raw material prices. This would lead to a decline in household purchasing power and worsen personal consumption. Furthermore, if corporate profits are squeezed, leading to reduced capital investment, and if this also leads to a deterioration in the employment and income environment, the negative impact on personal consumption would be even greater.

Using our short-term macro model, we estimated the impact on the Japanese economy if WTI rises to $150/bbl in the Oct-Dec 2025 period through actions such as the closure of the Strait of Hormuz and remains elevated thereafter. The results are shown in Chart 6. Under the main scenario, the projected real GDP growth rate for FY2025, which was expected to be +0.7% y/y, would instead be +0.4% (a change of -0.3%pt). For FY2026, the growth rate would significantly decline from +0.8% to +0.3% (a change of -0.5%pt)[13].

Impact of Surging Crude Oil Prices (WTI, $150/bbl) on Real GDP Growth Rate **Chart 6**



Source: Various Sources; compiled by DIR.

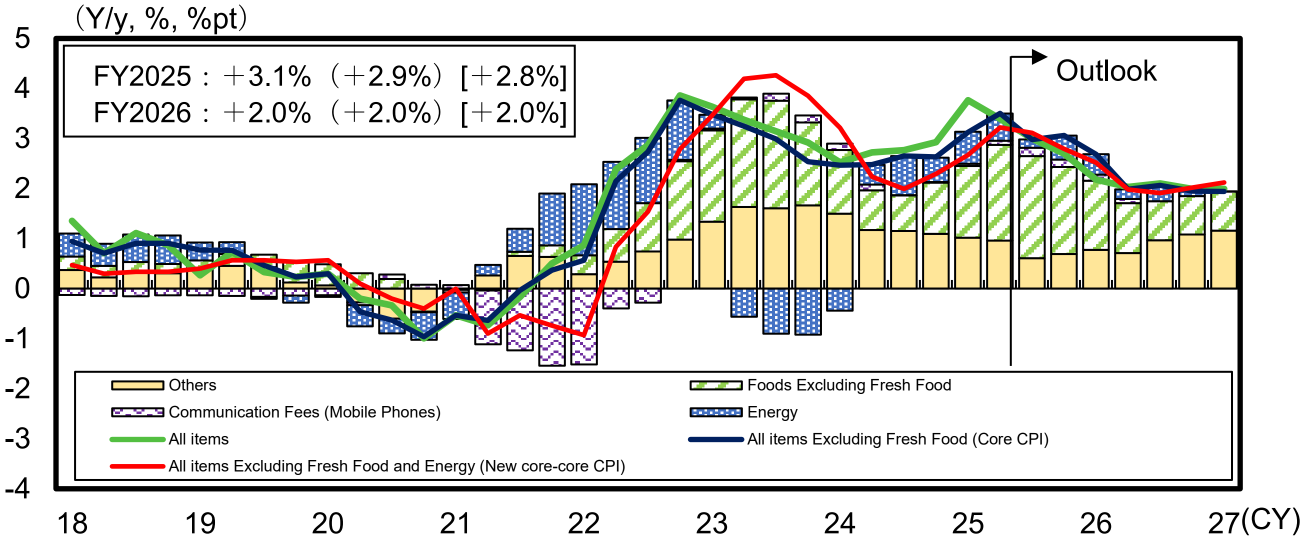
[13] The extent of the downturn in terms of level is estimated at 0.3% (¥1.8 tril) for FY2025 and 0.8% (¥4.5 tril) for FY2026.

Outlook for Prices and Monetary Policy

New core-core CPI expected to maintain at around +2% y/y in FY2026

On an all items basis, CPI is projected to increase by +2.8% y/y in FY2025, with +2.0% expected in FY2026. On an all items basis, less fresh food, core CPI is projected to increase by +3.1% y/y in FY2025, and +2.0% in FY2026 (Chart 7). Meanwhile, on an all items basis, less fresh food and energy (new core-core CPI), the forecast is +2.9% in FY2025 and +2.0% in FY2026. All are expected to experience a slowdown in growth rate during the first half of FY2026.

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

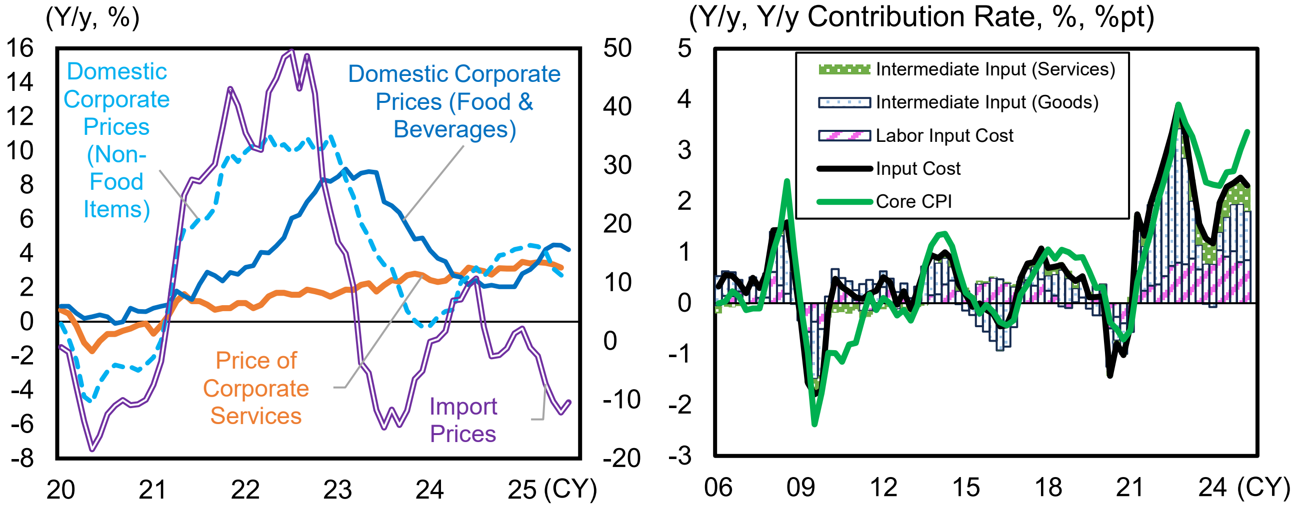


Source: Ministry of Internal Affairs and Communications; compiled by DIR.
Note: Price outlook assuming resource prices and exchange rates at the time of this writing. Assumes phased implementation of a 10 yen/liter gasoline subsidy (5 yen/liter for kerosene) through end of September.

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, in addition to fixed subsidies for gasoline and kerosene, the government plans to subsidize electricity and gas bills for July through September.

The growth rate in food prices, which has been the main source of recent growth in prices, is expected to slow gradually. The growth rate in rice prices, which had almost doubled at one point on a y/y basis, have recently been on the decline, and are expected to continue to do so. However, the ripple effect on related products is expected to continue for the time being. Chart 8 (left) shows the y/y changes in the various price indices. While import prices (yen-based) continue to show significant declines, prices of domestic corporate goods – particularly for food and beverages – remain at high levels even now. Even if the surge in rice prices itself subsides, the ripple effects on related items are likely to persist for the time being. Consequently, the rate of increase in food prices will not easily slow for some time.

Trends in Various Price Indices (Left), Trends in Corporate Input Costs and CPI (Right) Chart 8



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

Note: The input costs shown in the chart on the right were calculated using the Corporate Goods Price Index (Bank of Japan), the Corporate Services Price Index (Bank of Japan), the Monthly Labour Survey (Ministry of Health, Labour and Welfare), and other sources. The rate of change in input costs for each industry was derived from the intermediate input weights and labor input weights in the 2015 Input-Output Tables. These rates were then weighted by household final consumption expenditure to produce the weighted average values.

We expect the trend of passing on increased labor costs to sales prices to continue. Examining the trend in corporate input costs estimated from input-output tables and various wage and price statistics alongside core CPI in Chart 8 (right) reveals that, influenced by the aforementioned surge in rice prices, the y/y contribution of intermediate input (goods) has expanded recently.

On the other hand, the y/y contribution rate of labor input cost has maintained at a stable +1%pt, and is one of the major factors in supporting the sustainability of growth in prices. As was mentioned previously, a high rate of increase in wages was realized as a result of the 2025 spring labor negotiations. With the structural problem of labor shortages as background, the move toward raising wages by corporations is expected to continue. The move toward passing along the increase in associated labor costs to sales prices will also likely continue. In fact, the growth rate of the corporate services price index, which is sensitive to labor costs, is expanding, albeit slowly (Chart 8, left). Supported by these trends, we expect underlying prices to remain at around +2% y/y through FY2026.

BOJ expected to resume raising short-term rates within the year (2025), and subsequently continue raising rates at a moderate pace

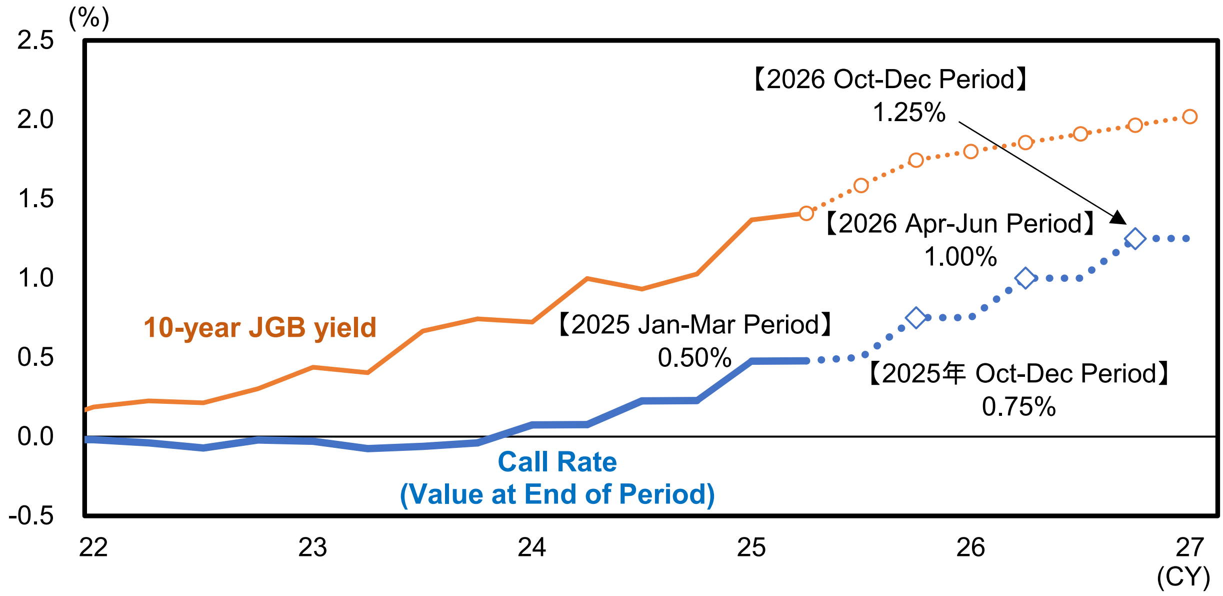
We assume that the BOJ will raise the short-term interest rate to 0.75% in the Oct-Dec 2025 period, followed by additional rate hikes at a pace of once every six months, 0.25%pt at a time (reaching 1.25% by the Jan-Mar period of 2027, the end of the forecast period, Chart 9).

Our main scenario expects that Japan's economy will continue its gradual recovery despite the adverse effects of Trump tariffs. Furthermore, considering domestic wage and price trends, the need for interest rate hikes to adjust the degree of monetary easing remains significant. The BOJ is expected to resume raising rates within 2025 while paying close attention to the economic impact of Trump tariffs.

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%.

We expect the long-term interest rate to rise to around 2% toward the end of the forecast period (Chart 9). 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 9**



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. 226 (August 21, 2025) Chart 10

		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	555.9	557.5	560.8	561.6	563.0	562.2	562.9	564.3	565.7	567.0	568.4	569.9	558.9	563.0	567.7
	Q/q %	0.7	0.3	0.6	0.1	0.3	−0.1	0.1	0.2	0.2	0.2	0.2	0.3			
	Q/q %; annualized	3.0	1.1	2.4	0.6	1.0	−0.6	0.6	1.0	1.0	1.0	1.0	1.0			
	Y/y %	−0.7	0.8	1.2	1.8	1.2	0.8	0.5	0.5	0.5	0.9	0.9	1.0	0.8	0.7	0.8
														(0.1)	(1.1)	(0.7)
Private Consumption	Q/q %	0.9	0.7	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.8	0.9	0.9
Private Residential Investment	Q/q %	1.5	0.8	−0.1	1.4	0.8	−1.5	−0.9	−0.5	−0.6	−0.7	−0.7	−0.8	−0.4	0.3	−2.9
Private Non-Resi. Investment	Q/q %	1.2	0.1	0.5	1.0	1.3	−0.8	0.0	0.3	0.4	0.4	0.4	0.4	2.0	1.8	1.0
Government Consumption	Q/q %	1.0	0.0	0.2	−0.5	0.0	0.4	0.3	0.3	0.3	0.3	0.3	0.3	1.3	0.3	1.3
Public investment	Q/q %	2.5	0.1	−0.8	0.1	−0.5	0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.8	−0.3	0.5
Exports	Q/q %	1.1	1.3	1.9	−0.3	2.0	−1.8	−0.5	0.5	0.6	0.6	0.7	0.7	1.7	1.5	1.2
Imports	Q/q %	3.1	2.0	−1.5	2.9	0.6	−1.0	−0.4	0.5	0.5	0.5	0.6	0.6	3.4	1.7	1.3
Nominal GDP	Q/q %; annualized	9.1	2.6	5.3	3.9	5.1	0.3	2.3	2.7	2.6	2.5	2.5	2.6	3.7	3.3	2.4
GDP deflator	Y/y	3.1	2.4	2.9	3.3	3.0	2.8	2.4	2.1	1.5	1.6	1.6	1.5	2.9	2.6	1.6
Industrial production	Q/q	2.1	0.3	0.4	−0.3	0.4	0.0	0.3	0.4	0.3	0.4	0.4	0.5	−1.4	0.7	1.4
Core CPI	Y/y	2.5	2.7	2.6	3.1	3.5	3.0	3.1	2.7	2.0	2.1	1.9	1.9	2.7	3.1	2.0
Unemployment rate	%	2.6	2.5	2.5	2.5	2.5	2.4	2.3	2.3	2.3	2.3	2.3	2.3	2.5	2.4	2.3
Trade balance (goods, services)	Y tril; annualized	0.08	0.23	0.23	0.48	0.48	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	1.41	1.59	1.75	1.80	1.86	1.91	1.97	2.02	1.08	1.64	1.94
Major assumptions																
Crude oil price (WTI futures)	$/bbl	80.7	75.3	70.3	71.4	63.7	64.4	62.3	62.3	62.3	62.3	62.3	62.3	74.4	63.2	62.3
Exchange rate	Yen/$	155.8	149.1	152.4	152.5	144.6	147.5	147.7	147.7	147.7	147.7	147.7	147.7	152.4	146.9	147.7

Source: Compiled by DIR.

Note: Shaded areas are DIR estimates. The estimated 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) till the end of September.