Japan | Fixed Income

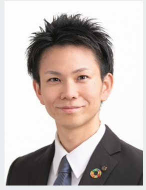
16 May 2025
Japanese report: 16 May 2025

Daiwa's Economic View

Jan-Mar 2025 GDP: Economy shrank on worsening external demand

- GDP turned negative for Jan-Mar on weakening external demand
- Currently see moderate recovery, but economy not particularly strong before tariffs
  Also see significant downside risk going forward
- Virtuous cycle of "higher wages → higher prices" stalling for now due to Trump tariffs

FICC Research Dept.



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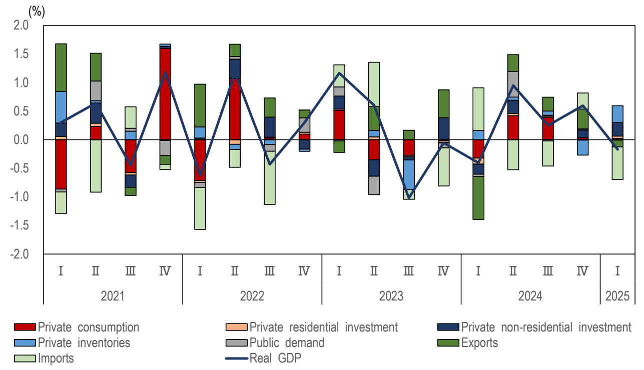
Negative Jan-Mar 2025 real GDP on poor external demand, serious downside risks

Jan-Mar 2025 real GDP (first preliminary estimates) released on 16 May showed that Japan's economy shrank 0.2% q/q (-0.7% annualized). The result was weaker than the market forecasts for a contraction of 0.1% (-0.3% annualized), marking the first decline in four quarters. This negative growth was due to a rebound for imports and weakening private consumption. The main reason was the rebound for imports. As for domestic demand, private consumption remained flat (+/-0% q/q), but capex increased significantly (+1.4%) and the overall domestic demand contribution was also positive (+0.7%). Meanwhile, the external demand contribution deteriorated to -0.8%.

The Jan-Mar quarter was a period of heightened concern regarding the Trump tariffs. In February, there was a temporary increase in exports due to rush of shipments to the US. However, overall, we could not confirm a cautious approach to capex due to a deteriorating business sentiment. If only the last-minute surge in demand is taken into account, the impact on the economy, including any subsequent reactionary decline, should be neutral over the long run. In light of this, the hard data for the Jan-Mar quarter did not show any significant negative impacts from the Trump tariffs.

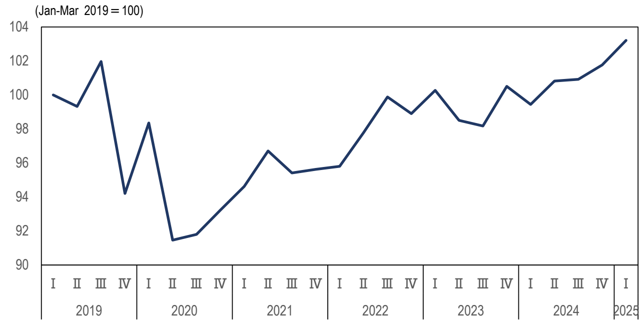
We were particularly concerned about the initial negative impact of the Trump tariffs on capex. However, real private non-residential investment (= capex) in the Jan-Mar quarter increased for the second straight quarter, +1.4% q/q (+0.8% in Oct-Dec 2024) due to solid investment in capital goods and software. DX (digital transformation) investment is on the rise amid the Japan's structural labor shortages and, at this point, there is no indication that investment in production equipment is being restrained in anticipation of the Trump tariffs. That said, the Trump tariffs are likely to be fully implemented from April, so there is still the high risk that capex could be restrained going forward.

Chart 1: Breakdown of Contributions to Real GDP



Source: Cabinet Office; compiled by Daiwa.

Chart 2: Level of Private Non-residential Investment



Source: Cabinet Office; compiled by Daiwa.

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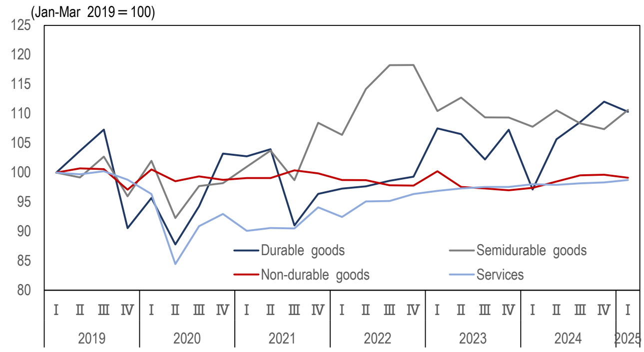
Also, real private consumption was unchanged in Jan-Mar at ±0.0% q/q (+0.1% for Oct-Dec). The private consumption deflator rose sharply to +1.5% q/q (+0.2% in Oct-Dec) with soaring prices cited as a factor in pushing down consumer spending. By goods, durable goods declined by 1.5% (+3.2% in Oct-Dec) due to a drop in automobile sales following plant shutdowns in early March and sluggish sales of home appliances. Non-durable goods consumption fell 0.5% (+0.1% in Oct-Dec) amid rising prices, especially for food.

Meanwhile, service consumption, which accounts for about 60% of consumption expenditures, was +0.4% q/q (+0.2% in Oct-Dec) due to strong growth for dining out and lodging, among others. Semi-durable goods also showed signs of picking up, increasing +3.0% (-0.9% in Oct-Dec), a rebound from the decline in the Jul-Sep quarter. Consumer spending remained in a flat range when discounting these factors.

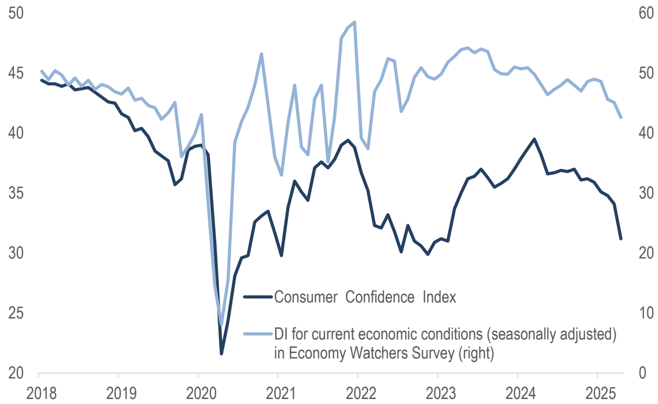
However, looking ahead, we expect no change to the moderate recovery trajectory for consumption due to the strong results of the 2025 annual spring labor-management wage negotiations and the gradual weakening of cost-push pressure on prices due to unfavorable weather and other factors, which will also reduce the growth of non-durable goods prices. Meanwhile, at this juncture, the situation is such that the risk of a recovery scenario is increasing. This is because consumer confidence has declined significantly due to the effects of the Trump tariffs, in addition to soaring prices.

Chart 3: Levels of Household Consumption by Type



Source: Cabinet Office; compiled by Daiwa.

Chart 4: Consumer Sentiment



Source: Cabinet Office; compiled by Daiwa.

Goods exports were +0.4% q/q (+0.3% in Oct-Dec). This was partly due to a significant increase in last-minute exports to the US in February. That said, exports to the US declined in March. This decline in March was due to a pullback following the surge in export demand in February, while such last-minute exports in March were not as robust as those in February. Still, the exporting of goods to the US and Asia was generally solid throughout the Jan-Mar quarter.

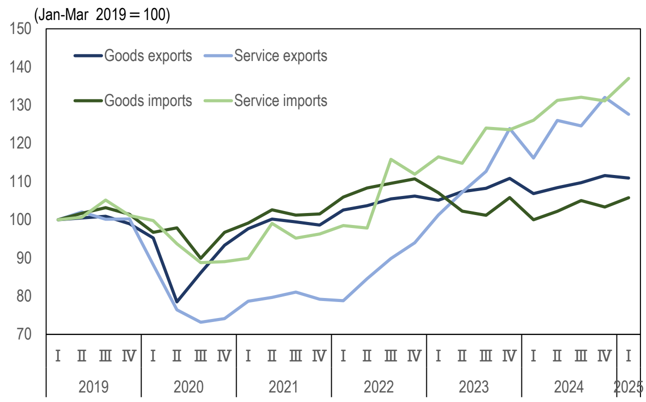
Meanwhile, exports of services were -3.4% q/q (+6.0% in Oct-Dec). The export of services has been weak due to a reactionary decline in other services (such as R&D services), which increased significantly in the previous quarter. The growth for services provided to foreign tourists visiting Japan (included in Japan's export of services) also slowed. When discounting these factors, overall exports were -0.6% (+1.7% in Oct-Dec).

Also, in reaction to the sharp decline in the previous quarter, imports of both goods and services rebounded substantially to +2.9% q/q (-1.4% in Oct-Dec). Since an increase in imports makes a negative contribution to GDP, the overall external demand contribution was -0.8% and this was the main factor pushing down real GDP in Jan-Mar.

In general, the Jan-Mar GDP result was pushed lower mostly due to the rebound (large increase) in imports from the previous quarter. Even though there are concerns about weakening private consumption, domestic demand remains strong, supported by capex and other factors. Taking into consideration also the Oct-Dec 2024 quarter, when the positive trend expanded due to a large decrease in imports, the Jan-Mar GDP result is probably not enough to change our assessment that the Japanese economy remains on a gradual recovery path. That said, the current economic tone itself is not strong. It is also true that the economic buffer needed to withstand tariff shocks is small.

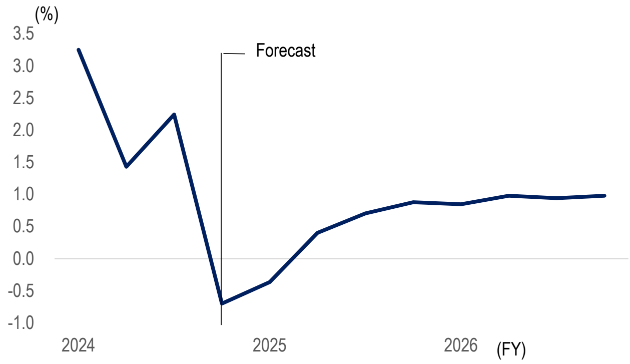
The economic situation in the Apr-Jun quarter and beyond will be noteworthy in light of the Trump tariffs, which increases the risk of downward pressure on the economy going forward. At this juncture, real GDP for Apr-Jun 2025 is expected to contract 0.4% q/q annualized, to mark a second straight quarter of negative growth, given the restrained spending (consumption and capex) due to uncertainties and the decline in exports due to the impact of tariffs and other factors.

Chart 5: Exports and Imports by Type



Source: Cabinet Office; compiled by Daiwa.

Chart 6: Forecast for Real GDP



Source: Cabinet Office; compiled by Daiwa.

Virtuous cycle of wages and prices stalled for now due to Trump tariffs

The BOJ focuses on unit labor cost (ULC) and unit profit (UP) to confirm whether a virtuous cycle (passing on of wage hikes to prices) has been realized. ULC represents the labor cost per unit of value added that is produced and represents the labor cost required for a company to create value. Meanwhile, UP refers to the profit earned by a company per unit of value added that is produced. This is an indicator that measures the profitability of a company.

Ideally, both ULC and UP should be extended in a balanced manner. For that to happen, not only must wages rise, but corporate profits must also increase sufficiently. To achieve that objective, it is important to have (1) improved labor productivity, (2) an environment in which the wage increase portion can be passed to prices, and (3) stable demand. By doing so, a virtuous cycle will be created in which rising wages do not put pressure on corporate profits, leading to sustained economic growth overall. BOJ Governor Kazuo Ueda described this as a force that leads to, "Further price rises through the linkage between wages and prices, mainly against the backdrop of tightening labor market conditions while the economy improves." This suggests to us that the virtuous cycle (passing on of wage hikes to prices) can be realized.

◆ **Jan 2025 *Outlook for Economic Activity and Prices* report (released 27 Jan 2025)**

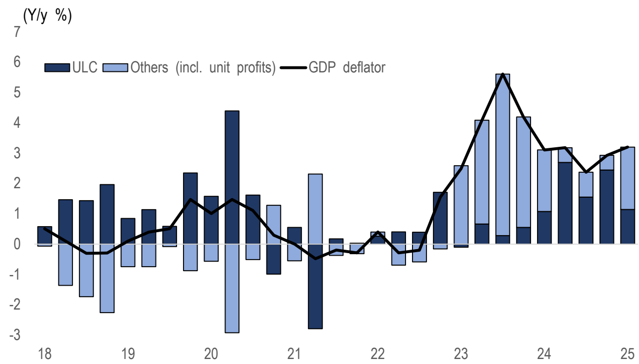
- The GDP deflator, which indicates domestic inflationary pressure, grew at a fast pace in 2023, mainly in unit profits, as firms passed on cost increases. On the other hand, since the start of 2024, the contribution of unit labor costs has been intensifying, reflecting wage increases. With wages and prices rising moderately, the growth rates of unit profits and unit labor costs are likely to become balanced.

The GDP deflator for Jan-Mar 2025 was +3.3% y/y (+2.9% in Oct-Dec), with both the ULC and UP rising. Compared to the previous quarter, the UP contribution increased, while the ULC decreased. Also, the ULC decrease from the previous quarter is attributed to a drop in wages per capita and an increase in labor productivity (real GDP / number of workers).

The decrease in per capita wages was mainly due to the absence of winter bonus increases seen in the previous quarter. Also, the increase in labor productivity was due to the higher rate of increase for added value (real GDP) compared to the same quarter last year. That said, Jan-Mar 2024 was a period when GDP declined significantly due to the shutdown of automobile plants. So, this q/q increase in productivity should be discounted and assessed. In fact, the level of labor productivity itself has declined since the previous quarter.

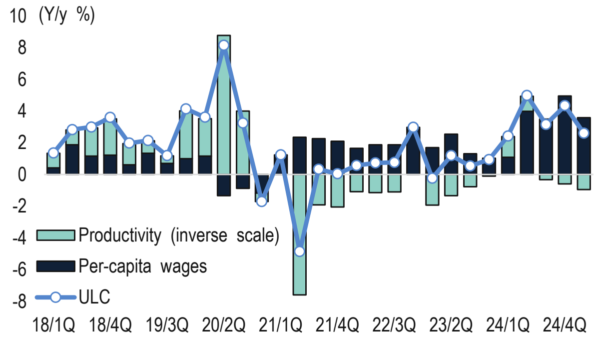
However, the level of labor productivity is not noticeably low and, at this juncture, we can say that an endogenous and sustained upward movement of prices is continuing. That said, real GDP is expected to weaken further in the Apr-Jun quarter and the level of labor productivity is likely to decline further. Meanwhile, considering the high rate of wage increases in the annual spring labor-management wage negotiations in 2025, we expect a development in which UP (corporate profits) will shrink, while ULC (labor costs) will increase. As such, it is unlikely that ULC and UP will realize balanced growth in the Apr-Jun quarter.

Chart 7: Breakdown of GDP Deflator



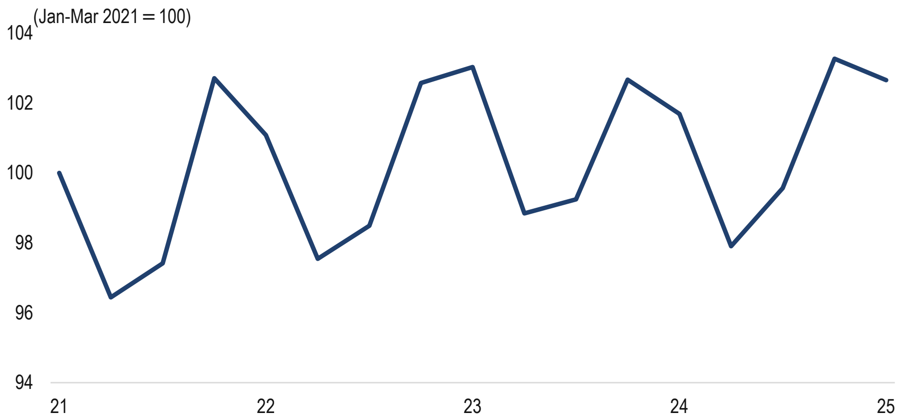
Source: Cabinet Office; compiled by Daiwa.
Note: ULC = Nominal employee compensation / Real GDP.

Chart 8: Breakdown of ULC



Source: Cabinet Office, Ministry of Internal Affairs and Communications (MIC); compiled by Daiwa.

Chart 9: Level of Per-capita Labor Productivity



Source: Cabinet Office; MIC; compiled by Daiwa.

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