Daiwa Securities

Daiwa's Economic View

Outlook for Japan's economy, policy rate (May 2025)

- Jan-Mar 2025 GDP expected to decline q/q, but actual circumstances likely not bad
- Japan's economic outlook: Expect +0.4% y/y real growth rate for FY25
- Expect next BOJ rate hike in Jan-Mar 2026

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Jan-Mar 2025 GDP expected to decline q/q, but actual circumstances likely not bad

We expect real GDP for Jan–Mar 2025 to decline by 0.1% q/q (an annualized decline of 0.5%), the first negative growth in four quarters. However, the decline is mainly due to a rebound in imports, which fell sharply in the previous quarter. Domestic demand, such as personal consumption and capex, is expected to remain firm. Therefore, we think the actual circumstances are not as bad as the headline figure suggests, and the underlying economic trend will remain solid.

Looking at the figures pertaining to personal consumption, we expect consumption of services such as dining out and accommodation to have increased steadily, despite weak consumption of non-durable goods due to the rising price of food and similar items. As for capex, while construction investment is somewhat sluggish, investment in machinery and software is expected to be solid. Therefore, an upward trend is likely to continue as a whole.

However, external demand is likely to decline. With regard to exports, service exports are expected to be sluggish due to a reactionary decline in other business services (such as R&D services), which had surged in the previous quarter. Meanwhile, exports of goods, particularly items such as automobiles to the US and Asia, are expected to increase, partly due to last-minute demand for items to the US. As for imports, both goods and service imports are expected to increase substantially in response to the plunge that occurred in the previous quarter. As a result, the increase in imports is likely to make a negative contribution to external demand, and the increase in domestic demand is expected to be offset by a decline in external demand.

Chart 1: Forecasts for Major Economic Indicators (%)

				→Forecasts*									→Forecasts*			
	FY24				FY25				FY26				FY24	FY25	FY26	FY27
	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 growth rate (q/q)	0.8	0.4	0.6	-0.1	-0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	-	-	-	-
(annualized)	3.2	1.4	2.2	-0.5	-0.6	0.5	0.8	0.7	0.7	0.8	0.7	0.9	0.7	0.4	0.7	0.9
Domestic demand contribution (q/q)	1.1	0.5	-0.2	0.4	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2	1.1	1.0	0.9	0.9
Private consumption (q/q)	0.8	0.7	0.0	0.2	0.1	0.1	0.1	0.2	0.3	0.2	0.3	0.2	0.9	0.7	0.8	0.9
Private non-residential investment (q/q)	1.1	-0.1	0.6	1.0	-0.6	0.1	0.2	0.2	0.3	0.4	0.3	0.4	2.1	0.6	1.1	1.6
Foreign demand contribution (q/q)	-0.3	-0.1	0.7	-0.5	-0.4	-0.1	0.0	0.0	-0.1	0.0	0.0	0.0	-0.3	-0.5	-0.1	-0.1
Exports (q/q)	1.7	1.5	1.0	0.4	-2.1	-0.3	0.4	0.4	0.4	0.6	0.5	0.6	1.8	-0.9	1.7	2.4
Imports (q/q)	3.0	2.0	-2.1	2.7	-0.3	0.4	0.5	0.5	0.7	0.6	0.7	0.6	3.6	1.8	2.4	2.7
Core CPI (y/y)	2.5	2.7	2.6	3.1	3.1	2.2	2.0	1.6	1.7	1.9	1.7	1.7	2.7	2.2	1.7	1.8
Core core CPI (y/y)	2.2	2.0	2.3	2.7	2.8	2.4	1.9	1.7	1.8	1.8	1.7	1.7	2.3	2.2	1.7	1.9
Uncollateralized overnight call rate	0.0～0.1	0.25	0.25	0.50	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	0.50	0.75	1.00	1.00

Source: Cabinet Office, Ministry of Internal Affairs and Communications (MIC), BOJ, Bloomberg; compiled by Daiwa.
**Forecasts by FICC Research Department.*

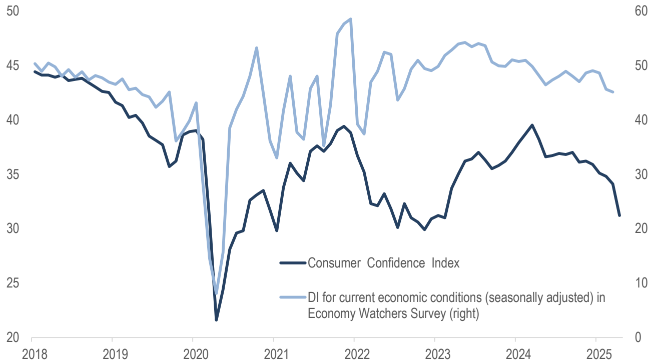
Trump tariffs and economic outlook from FY25 onwards

The focus of interest going forward will be on economic trends from Apr–Jun 2025 onwards, when the impact from Trump tariffs is expected to become more serious. These tariffs will have a broad impact on Japan's exports and other activities by way of a slowdown in the global economy, in addition to direct downward pressure on exports to the US. The increased uncertainty will also likely restrain corporate capex, which will affect production activities and personal consumption.

Given this impact, we forecast that FY25 real GDP will grow 0.4% y/y. However, this figure includes a carryover effect, so the growth rate will be close to zero in real terms. This is premised on reciprocal tariffs on Japan being 10% and tariffs by item (automobiles/auto parts, iron/steel, aluminum, semiconductors, and pharmaceuticals) being 25%.

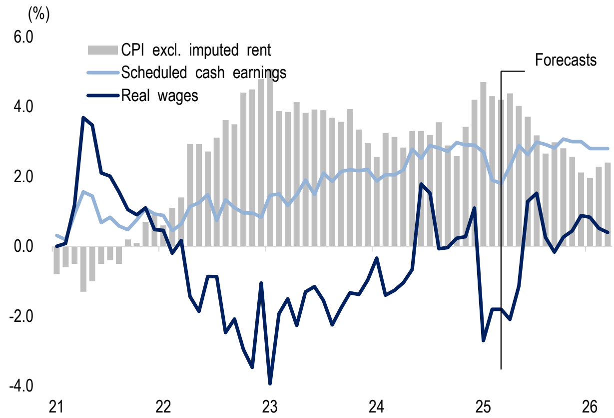
Personal consumption is expected to recover gradually as (1) the favorable outcome of 2025 spring wage negotiations will likely contribute to income growth and (2) the CPI growth rate is projected to fall below 2% at end-2025 in line with a gradual slowdown in the inflation rate. However, consumer sentiment is currently deteriorating due to higher prices and uncertainty about tariffs, which may negatively affect consumer spending going forward (Chart 2). Moreover, FY25 corporate earnings are expected to face downward pressure from tariffs, and the increase in 2025 winter bonuses is likely to be curbed. We maintain our view that real wages will not see a full-scale shift towards positive growth until the latter half of 2025 (Chart 3). The restrained growth in bonuses is expected to slow the pace of the recovery in consumer spending (via an improved income situation).

Chart 2: Consumer Sentiment



Source: Cabinet Office; compiled by Daiwa.

Chart 3: Forecasts for Real Wages

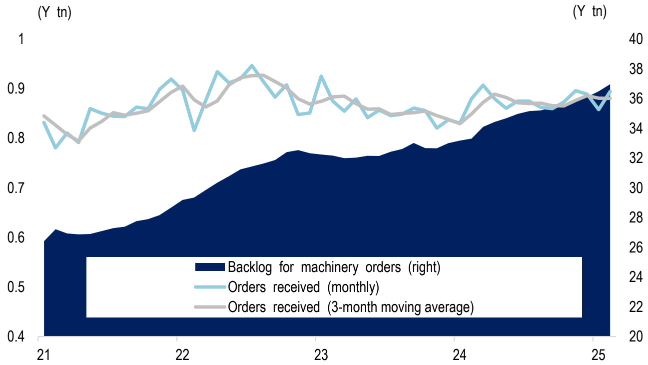


Source: MIC, Ministry of Health, Labour and Welfare; compiled by Daiwa.

Capex for the purpose of increasing production is expected to be restrained due to increasing uncertainty. However, capex overall will likely be supported by demand for investments related to digital transformation (DX) against the backdrop of Japan's structural labor shortages, as well as the growing backlog for machinery orders (Chart 4). Under these circumstances, capex is expected to decline in the Apr-Jun 2025 quarter, but then gradually pick up thereafter.

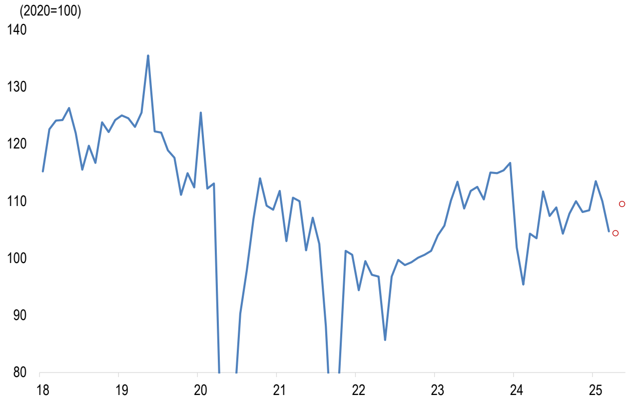
At this juncture, we do not see any significant Trump tariff impacts on the production activities of Japanese corporations. According to the 30 April Indices of Industrial Production (survey date: 10 Apr), the transport equipment production outlook is expected to decline for the second straight month in April (-0.3% m/m), but should again pick up in May (+4.9%) with no indication of a major decline (Chart 5). That said, the survey date was during a period of heightened uncertainty due to Trump's tariff policy and so these effects may not have been fully factored in. It is highly likely that the negative effects of the Trump tariffs will materialize in future production-related indicators.

Chart 4: Machinery Order Statistics



Source: Cabinet Office; compiled by Daiwa.

Chart 5: Industrial Production Index, Industrial Production Forecast Index (transport equipment)



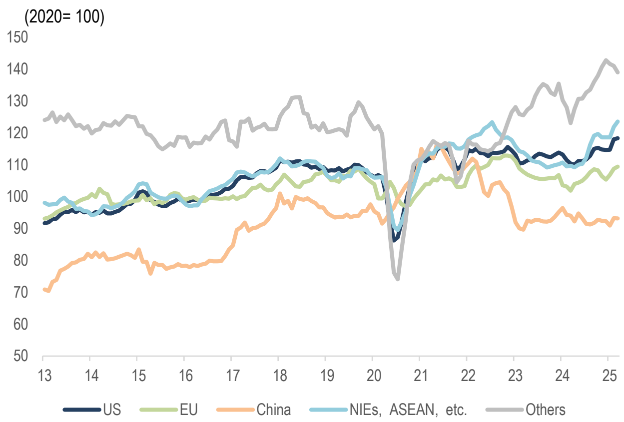
Source: Ministry of Economy, Trade and Industry; compiled by Daiwa.

Meanwhile, the impact of the Trump tariffs has already been seen in export trends through March. Exports to the US (especially automobiles) increased during the Jan-Mar quarter of 2025 and a last-minute rush to export cars before higher tariffs took effect was seen (charts 6, 7). However, from April onward, we expect many other exports to come under downward pressure due to declining competitiveness and reduced demand caused by full-fledged tariffs, in addition to a pullback following the abovementioned rush to export automobiles before tariffs took effect. We expect export growth to slow for the time being (Apr-Jun 2025 onward) and turn negative q/q toward Jul-Sep 2025. Such a decline in exports will put downward pressure on corporate earnings and could even impact the 2026 annual spring labor-management wage negotiations.

Chart 6: Real Imports and Exports

Source: BOJ; compiled by Daiwa.
Note: 3-month moving average.

Chart 7: Real Exports (by trade partner)



Source: BOJ; compiled by Daiwa.
Note: 3-month moving average.

Impact of Trump tariffs on corporate earnings, wage increases

The Trump tariffs will have multifaceted negative impacts on Japanese companies in terms of reduced price-competitiveness, increased procurement costs, the need to restructure supply chains, and even a slowdown in the global economy.

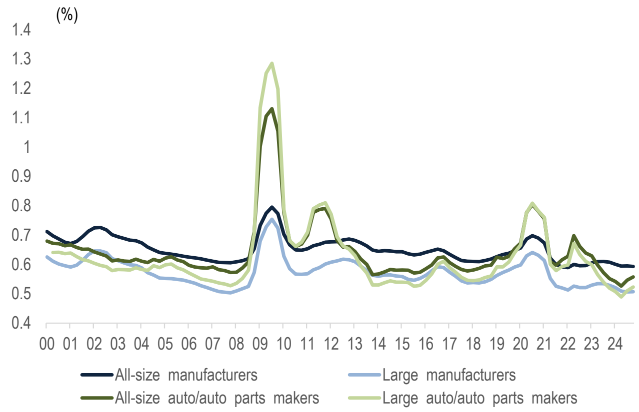
Our estimates, based on the value of exports to the US in FY24 and assuming a reciprocal tariff of 10% and an item-specific tariff of 25% (automobiles (incl. auto parts), steel, aluminum, semiconductors, pharmaceuticals), assume the overall burden from the additional tariffs will come to approximately Y3.7tn (incl. Y1.5tn for automobiles, Y0.3tn for auto parts).

There is the assumption that the tariff costs will be borne by (1) passing on higher costs to prices on the US side, (2) Japanese firms bearing these costs, or (3) both parties sharing the costs. If Japanese companies were to bear the full burden, recurring profit for the entire manufacturing industry (about Y41.3tn in 2024) would decrease by roughly Y3.7tn (down 8.9%).

However, actual burdens will depend on market competition, the supply-demand balance, forex trends, US market price elasticity, and other factors. As such, Japanese companies will not have to bear the entire cost. Meanwhile, even if such costs are passed to the US side, Japanese companies could still be adversely impacted by reductions in terms of demand and exports. Also, we should note that this burden itself is also a simplified estimate and will vary depending on the actual export value, customs clearance prices, forex fluctuations, and tariff avoidance measures (local production, change of suppliers, expansion into other markets, others) taken by each company.

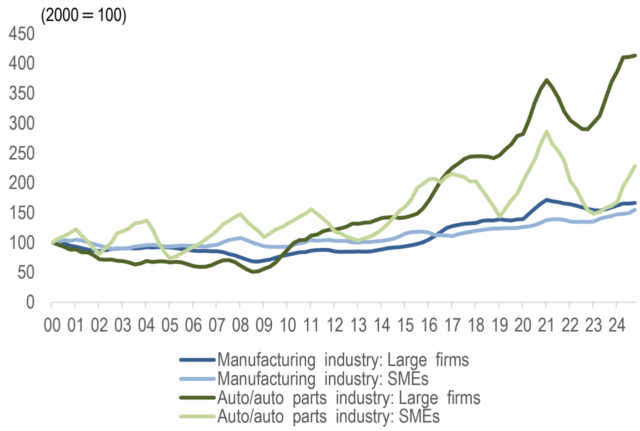
Turning to wage hikes, inflation is expected to settle around 2% at the time of the 2026 annual spring labor-management wage negotiations and downward pressure on corporate earnings in 2025 could become a factor that restrains wage hikes. Meanwhile, as for the manufacturing industry, such as the automobile industry, labor share has been declining due to increased profits from yen depreciation. Even in the event of a temporary shock, there should still be a certain amount of leeway for further wage increases (charts 8, 9). In addition, due to the structural issue of labor shortages, we can probably expect the 2026 annual spring labor-management wage negotiations to produce a certain wage increase level from the perspective of securing human resources over the long term.

Chart 8: Labor Share in Manufacturing and Auto Industries



Source: MOF; compiled by Daiwa.

Chart 9: Cash and Deposits (stock) in Manufacturing and Auto Industries



Source: MOF; compiled by Daiwa.

Policy rate outlook: Expect next rate hike in Jan-Mar 2026

During his press conference following the May Monetary Policy Board meeting, BOJ Governor Kazuo Ueda stressed "uncertainties," specifically the trade policies of other countries and overseas economic and price trends. Furthermore, the BOJ's April 2025 *Outlook Report*, included a significant downward revision to its forecast for Japan's economic growth rate. Also, this indication that reaching the BOJ's price stability target could be delayed by about one year has also pushed back the pace of interest rate hikes in real terms. Meanwhile, the BOJ has maintained its basic stance of raising interest rates if economic and price conditions remain in line with their new outlook.

However, at the same time, the BOJ also indicated that tariff shocks could cause underlying prices to temporarily stall. In that case, it would not hike interest rates. The condition for the next rate hike is probably "expected improvements following a standstill in underlying inflation (= increased accuracy)."

A standstill for underlying inflation is due to (1) deterioration in corporate earnings and slowdown in wage growth rate due to Trump tariff policy and (2) reduced consumer/investment confidence due to increased uncertainties, which lead to declines in companies' eagerness to pass on costs to prices. Such conditions could lead to a return to cost-cutting behaviors.

Under such conditions, the scope of downward pressure on corporate earnings, winter bonus trends, and the realization of wage increases from the 2026 annual spring labor-management wage negotiations (= continuation of the virtuous cycle between higher wages and higher prices) will all serve as important turning points. An early monetary policy revision is possible provided that tariff policy impacts are limited and corporate earnings are expected to remain steady, along with higher prices. However, as US Treasury Secretary Scott Bessent said that the tariff policy outlook will not become clearer until the Jul-Sep quarter, uncertainty is expected to remain high for the time being. A scenario in which there is little impact on business trends is not realistic. In fact, we have already seen a rush to export products (before tariffs take effect) and a deterioration in consumer confidence. Continued uncertainty could be a deterrent to sustained capex.

Against this backdrop, corporate earnings in FY25 are expected to come under increasing downward pressure, particularly in the manufacturing sector. However, at this juncture, we expect the level of wage increases in the 2026 annual spring labor-management wage negotiations to be maintained to a certain degree. This is because there is capacity to withstand tariff shocks, especially among large companies, while labor shortages persist. We expect the next interest rate hike to take place during the Jan-Mar 2026 quarter, after the BOJ confirms the results of the annual spring labor-management wage negotiations and other corporate trends.

If tariff policies inhibit the international division of labor and technology transfers, they could depress the natural rate of interest through a decline in total factor productivity (TFP) and contribute to a decline for the neutral rate of interest. That said, such structural changes are a longer-term issue and we expect the terminal rate for this rate-hiking phase to be around +1%, as before.

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