

## Section 2

# A REVIEW OF THE JAPANESE ECONOMY AND ITS SHORT-TERM OUTLOOK

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## 1. Review of the Japanese Economy: FY2024-2025

### (1) Recent Development and Outlook for the Global Economy

According to the World Trade Monitor published by the Netherlands Bureau for Economic Policy Analysis (CPB), global trade (volume basis; 2021 = 100) increased by 1.1% MoM in September 2025, marking the first increase in two months (previous month: -0.4% MoM). As a result, global trade rose by +1.1% QoQ in the July-September quarter; however, the pace of growth has continued to decelerate from the January–March period (+2.2% QoQ), following the April–June period (+0.6% QoQ). By region, trade in advanced economies increased by +0.4% QoQ in the July-September quarter, marking the first increase in two quarters (April–June period: -0.7% QoQ), while trade in emerging economies rose by +2.3% over the same period, although this represented a slowdown compared with the previous quarter (April–June period: +3.1%). From the second half of 2025 through 2026, global trade is expected to remain sluggish for some time, even though the effects of changes in U.S. tariff policy have begun to subside (Figure 3-2-1).

According to the World Semiconductor Trade Statistics (WSTS), global semiconductor sales (three-month moving average) in September 2025 increased

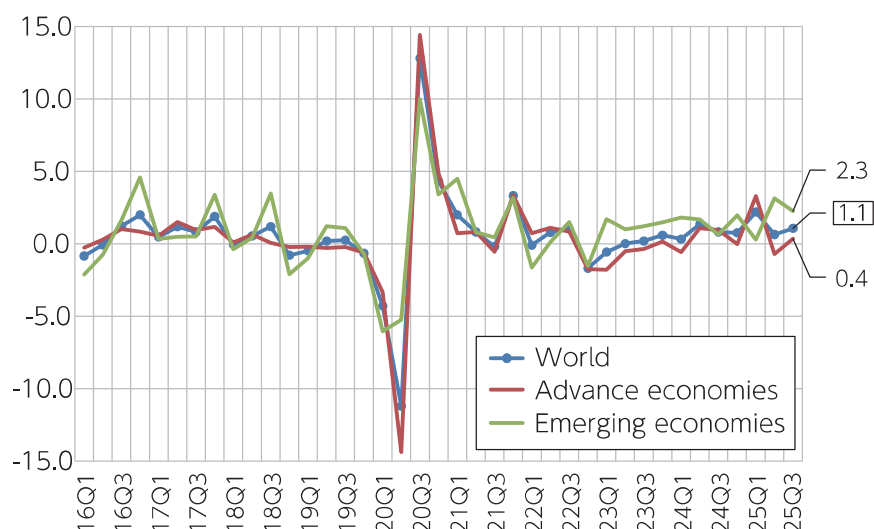


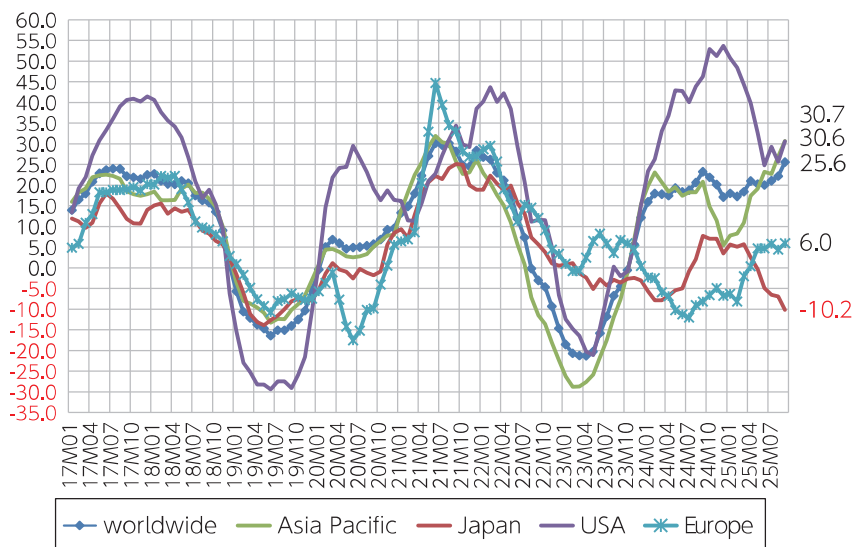
Figure 3-2-1

Changes in World Trade Volume (Units: QoQ, %)

by +25.6% YoY, marking the 23rd consecutive month of positive growth, with the growth rate still remaining in double-digit territory (previous month: +20.1% YoY). Supported by the expansion of AI-related demand, global semiconductor sales are expected to continue recovering for some time. By region, U.S. semiconductor sales increased by +30.6% YoY in September, marking the 23rd consecutive month of positive growth; however, a pronounced deceleration has become evident since the beginning of 2025 (from +50.8% in January to +30.6% in September). Asia also recorded growth of +30.7% YoY, extending its streak of positive growth to 23 consecutive months and posting double-digit growth for seven consecutive months. By contrast, Japan saw sales decline by -10.2% YoY, marking the fifth consecutive month of contraction, with signs of stagnation becoming increasingly apparent. Meanwhile, Europe posted a +6.0% YoY increase, extending its growth streak to six consecutive months (Figure 3-2-2).

According to the IMF (World Economic Outlook — Global Economy in Flux: Prospects Remain Dim, October 2025), global economic growth is projected at +3.2% in 2025 and +3.1% in 2026, representing somewhat slower growth compared with the actual outcome in 2024 (+3.3%). Relative to the previous projection (July 2025), the growth forecast for 2025 has been revised upward by +0.2 %, while the projection for 2026 remains unchanged (0.0 %). By contrast, a comparison between the October projection and the January projection shows that global economic growth has been revised downward by -0.1 % for 2025 and by -0.2 % for 2026. The Trump administration’s tariff policy continues to exert a dampening effect on growth.

Looking at the October projection by country and region, U.S. economic



**Figure 3-2-2** Changes in Global Semiconductor Sales: 3-month moving average (Units: YoY, %)

Source: World Semiconductor Trade Statistics, November 2025

growth is forecast at +2.0% in 2025 and +2.1% in 2026, while EU economic growth is projected at +1.4% in both 2025 and 2026. China's economy is expected to grow by +4.8% in 2025 and +4.2% in 2026. Relative to the July projection, the U.S. growth forecast has been revised upward by +0.1 % for both 2025 and 2026. For the EU, the forecast has been revised upward by +0.1 % for 2025, while the 2026 projection remains unchanged. With regard to China, the growth forecasts for both 2025 and 2026 remain unchanged.

In addition, growth in real global trade (goods and services) underlying these projections is forecast at +3.6% in 2025 (previous projection: +2.6%) and +2.3% in 2026 (previous projection: +1.9%). Compared with the previous projection, these figures represent upward revisions of +1.0 % and +0.4 %, respectively.

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## (2) Recent Development of the Japanese Economy

**[Second Preliminary GDP Estimate for the July–September Quarter: Positive Growth for a second Consecutive Quarter, but Decelerating from the Previous Quarter]**

According to the second preliminary GDP estimate for the July–September quarter, released on December 8, real GDP growth registered -0.6% QoQ and -2.3% at an annualized rate, marking the first contraction in six quarters. This represents a downward revision from the first preliminary estimate (-0.4% QoQ and -1.8% at an annualized rate). A comparison between the second and first preliminary estimates of real GDP growth shows that, with the exception of the January–March quarter of 2025, the figures for the October–December quarter of 2024, the April–June quarter of 2025, and the July–September quarter were all revised downward. As a result, the growth rate for FY2024 was slightly revised downward to +0.5% from the first preliminary estimate of +0.6%.

With the release of the second preliminary estimate at this time, in addition to the usual revisions from the first to the second preliminary estimate, the preliminary figures for FY 2024 were replaced with annual benchmark estimates. In addition, a base-year revision to the 2020 base was implemented. The main sources of revision were: (1) revisions to software investment; (2) revisions to real estate brokerage fees (investment); (3) revisions to construction investment; and (4) revisions to imputed rent for owner-occupied housing (consumption). Moreover, a change in estimation methodology was introduced through the implementation of an output-based construction deflator. As a result, the level of nominal GDP for FY 2024 was revised upward from 615.5 trillion yen to 642.4 trillion yen in the first preliminary estimate, representing an increase of 26.9 trillion yen (+4.4%).

Examining the contributions to real GDP growth in the July–September

**Table 3-2-1** Changes in real GDP and its demand-side components (Units: QoQ %, % points)

	Annualized GDP	GDP	Domestic demand	Private demand	Private final consumption expenditure	Private residential investment	Private non-residential investment	Private inventory changes	Public demand	Government final consumption expenditure	Public investment	Public inventory changes	Net exports	Exports	Imports	GDI
21Q2	3.0	0.7	1.1	0.7	0.7	0.7	1.6	0.0	0.4	2.8	-2.5	0.0	-0.3	2.4	4.8	0.3
21Q3	-0.6	-0.1	-0.3	-0.4	-0.9	-0.8	-1.0	0.3	0.0	0.5	-1.2	0.0	0.2	-0.8	-2.1	-0.6
21Q4	4.8	1.2	1.3	1.6	3.0	0.1	0.2	0.0	-0.2	-0.7	-1.6	0.0	-0.2	-0.6	0.4	0.7
22Q1	-1.5	-0.4	-0.4	-0.2	-1.0	0.3	0.9	0.1	-0.1	0.5	-4.8	0.0	0.0	4.0	3.9	-0.9
22Q2	4.0	1.0	1.2	1.0	1.6	-0.2	2.2	-0.2	0.1	1.1	-2.1	0.0	-0.2	0.6	1.5	0.4
22Q3	-1.4	-0.4	0.2	0.4	0.0	1.2	1.1	0.1	-0.2	-0.6	0.4	-0.1	-0.6	1.9	4.8	-0.9
22Q4	1.7	0.4	0.3	0.0	0.3	-0.5	0.0	-0.2	0.3	0.9	1.0	0.1	0.1	0.7	0.0	0.8
23Q1	2.9	0.7	0.5	0.3	0.4	0.6	1.2	-0.2	0.2	0.1	4.3	0.0	0.2	-0.8	-1.7	1.1
23Q2	1.1	0.3	-0.9	-0.5	-0.8	3.2	-1.4	0.1	-0.4	-1.3	-1.3	0.0	1.2	1.3	-3.7	1.1
23Q3	-5.3	-1.4	-1.3	-1.2	-0.7	-1.9	-0.5	-0.7	-0.1	0.0	-2.2	0.0	0.0	1.3	1.3	-1.1
23Q4	1.8	0.4	0.7	0.7	0.0	-0.4	2.6	0.2	0.0	0.0	-0.6	0.0	-0.2	2.4	3.1	0.3
24Q1	-2.1	-0.5	-0.7	-0.7	-0.3	-1.1	-2.4	0.0	0.0	0.3	-1.1	0.0	0.1	-3.7	-4.0	-0.7
24Q2	1.0	0.2	0.7	0.2	0.0	0.0	1.1	-0.1	0.5	2.2	1.1	0.0	-0.5	0.5	2.6	0.6
24Q3	2.7	0.7	0.9	0.8	0.5	0.8	0.6	0.4	0.0	-0.1	1.0	0.0	-0.2	2.2	3.0	0.7
24Q4	1.4	0.3	-0.5	-0.4	0.0	0.4	-0.2	-0.4	0.0	0.1	-0.6	0.0	0.8	1.7	-1.9	0.4
25Q1	1.5	0.4	0.9	1.0	0.7	0.0	0.2	0.6	-0.0	-0.3	-0.1	0.0	-0.6	-0.1	2.4	0.1
25Q2	2.1	0.5	0.4	0.4	0.3	0.4	1.3	0.0	0.1	0.3	0.0	0.0	0.1	1.9	1.4	1.1
25Q3	-2.3	-0.6	-0.4	-0.4	0.2	-8.2	-0.2	-0.1	-0.0	0.2	-1.1	0.0	-0.2	-1.2	-0.4	-0.5

Note: Domestic demand, private demand, private inventory change, public demand and net exports are contributions. Others are QoQ changes.

Source: National Accounts, Economic and Social Research Institute, Cabinet Office; "Preliminary Quarterly GDP Estimate for Q3 2025 (2nd Preliminary Figures)"

quarter (0.6% QoQ), domestic demand contributed -0.4 %pt, marking its first negative contribution in three quarters. Within this, private demand made a -0.4 %pt contribution, also its first negative contribution in three quarters. While private final consumption expenditure (+0.1 %pt) made positive contribution, private non-residential (-0.0 %pt) investment, private residential investment (-0.4 %pt) and changes in private inventories (-0.2 %pt) all made negative contributions. In addition, public demand contributed -0.0 %pt, marking its first negative contribution in two quarters.

By contrast, net exports contributed -0.2 %pt, representing the first negative contribution in two quarters. As both domestic demand and net exports weakened, real GDP recorded negative growth for the first time in six quarters (Table 3-2-1).

**[Developments in GDP Components in the July–September Quarter]** Nominal employee compensation increased by +0.6% QoQ, extending its streak of positive growth to 13 consecutive quarters, while real employee compensation—deflated by the household final consumption expenditure deflator—rose

by 0.3%, marking a second consecutive quarter of increase. As a result, private final consumption expenditure increased by +0.2% QoQ (contribution: +0.1 %pt), recording a third consecutive quarter of growth, albeit at a modest pace.

Within gross fixed capital formation, real private residential investment declined by -8.2% QoQ (contribution: -0.4 %pt), marking its first decrease in two quarters. In the July–September quarter, housing starts (annualized at 717,000 units) increased by +19.4% QoQ, posting their first increase in two quarters. In the April–June quarter, housing starts had fallen sharply by -32.3%, reflecting a reactionally decline front-loaded demand ahead of the revision to the Building Standards Act (January–March quarter: +14.1%). As private residential investment is measured on a progress basis, the reactionally decline the earlier surge in demand became evident in this category.

Real private non-residential investment declined by -0.2% QoQ (contribution: -0.0 %pt), marking its first decrease in three quarters. This can be regarded as a reaction to the strong growth recorded in the previous quarter (+1.3%). Nevertheless, business investment plans remain solid and corporate profits are at high levels, suggesting that the underlying upward trend continues.

The contribution of changes in private inventories to real GDP growth was -0.0 %pt QoQ, turning negative for the second quarters.

Real public demand decreased by -0.0% QoQ (contribution: -0.0 %pt), marking its first decrease in two quarters. Within this, real government final consumption expenditure rose by +0.2% (contribution: +0.0 %pt), recording a second consecutive quarter of growth. Meanwhile, real public fixed capital formation decreased by -1.1% QoQ (contribution: -0.1 %pt), marking its first decrease in two quarters.

Real exports of goods and services declined by -1.2% QoQ (contribution: -0.3 %pt), marking their first decrease in two quarters. Exports of goods fell by -1.1% (contribution: -0.2 %pt), registering their first decline in five quarters. In addition, exports of services—including direct purchases in Japan by non-resident households—declined by -1.6% (contribution: -0.1 %pt), also turning negative for the first time in two quarters. Within this category, direct purchases in Japan by non-resident households, which reflect inbound demand, increased by +0.1% QoQ (contribution: +0.0 %pt), marking a fourth consecutive quarter of growth.

By contrast, real imports of goods and services declined by -0.4% QoQ (contribution: +0.1 %pt), marking their first decrease in three quarters. Within this, imports of goods fell by -1.0% (contribution: +0.2 %pt), also posting their first decline in three quarters. Meanwhile, imports of services—including direct purchases abroad by resident households—increased by +1.1% (contribution: -0.1 %pt), extending their growth streak to three consecutive quarters.

Turning to deflators, the domestic demand deflator rose by +0.4% QoQ, marking a 19th consecutive quarter of increase. Within this, the private final consumption expenditure deflator increased by +0.4%, extending its rise to 19 consecutive quarters. The private residential investment deflator rose by +0.7%, marking a sixth consecutive quarter of increase, while the private non-residential investment deflator increased by +0.9%, extending its streak of positive growth to 19 consecutive quarters.

With respect to external demand deflators, the export deflator for goods and services increased by +1.8% QoQ, marking its first increase in three quarters, while the import deflator also rose by +1.2%, posting its first increase in two quarters (April–June quarter: -5.2%). As a result, the terms of trade improved for a second consecutive quarter.

Consequently, the GDP deflator increased by +0.5% QoQ, extending its rise to six consecutive quarters.

Owing to these developments, nominal GDP in the July–September quarter declined by -0.1% QoQ and by -0.2% at an annualized rate, marking its first decrease in six quarters.

### [July–September Quarter: Developments in GDP Components]

As real GDP in the July–September quarter (590.1 trillion yen) recorded negative growth for the first time in six quarters, it exceeded the pre-pandemic peak (July–September quarter of 2019: 584.0 trillion yen) for the fifth consecutive quarter, but the extent of expansion was limited to +1.0%. By contrast, partly reflecting the impact of rising prices, nominal GDP (635.8 trillion yen) exceeded its pre-pandemic peak (561.5 trillion yen) for the 15th consecutive quarter, posting an expansion of +15.6%.

Examining the recovery status of individual GDP components (Table 3-2-2), private final consumption expenditure remains slow to recover, standing at -1.2% relative to its pre-pandemic peak. Private capital formation in the January–March quarter exceeded the pre-pandemic peak for the first time (+0.6%), partly reflecting the impact of front-loaded demand for private residential investment; however, in the July–September quarter, it fell back below the peak (-0.4%) due to a reactionally decline that earlier surge. Supported by strong inbound demand, exports of services (+30.1%) have exceeded their pre-pandemic peak for 11 consecutive quarters. By contrast, imports of services—a deduction item in GDP accounting—have also exceeded their pre-pandemic peak (+31.3%) for 13 consecutive quarters.

Table 3-2-2

Adjustment process from the COVID-19 pandemic: Real GDP and its components (2019Q3=100)

	GDP	Goods Imports	Services Imports	Private final consumption expenditure	Private investment	Government spending	Goods exports	Services exports	Nominal GDP
19Q3	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
20Q2	90.4	94.8	89.1	89.2	92.6	102.1	78.2	76.3	91.9
20Q3	95.0	87.2	84.5	93.9	89.2	103.3	88.8	73.1	96.4
20Q4	96.5	93.7	84.7	95.6	89.8	104.0	97.7	74.1	98.0
22Q1	98.9	102.5	93.6	96.5	98.0	104.0	108.3	78.6	100.8
22Q2	99.9	104.8	93.1	98.1	98.8	104.6	107.7	84.2	101.5
22Q3	99.6	106.5	110.3	98.1	100.3	103.9	108.7	89.9	101.2
22Q4	100.0	107.2	106.3	98.5	99.6	105.1	108.5	94.1	103.2
23Q1	100.7	103.5	110.7	98.9	100.0	106.0	105.4	101.0	105.3
23Q2	101.0	98.8	109.2	98.0	99.7	104.5	106.0	106.4	107.3
23Q3	99.6	98.6	118.1	97.4	96.4	104.1	106.0	113.0	107.3
23Q4	100.0	102.4	117.4	97.4	99.3	104.0	106.3	124.1	108.4
24Q1	99.5	96.5	119.8	97.0	97.1	104.0	102.8	115.9	107.6
24Q2	99.7	98.7	124.7	97.1	97.8	106.1	101.3	124.5	109.8
24Q3	100.4	102.9	125.7	97.6	99.9	106.3	104.0	125.1	111.1
24Q4	100.7	100.3	124.3	97.6	98.3	106.1	104.7	132.4	112.3
25Q1	101.1	102.3	129.4	98.3	100.7	105.9	105.5	127.4	113.3
25Q2	101.6	103.7	130.4	98.5	101.8	106.2	107.3	132.8	115.6
25Q3	101.0	103.4	131.3	98.7	99.6	106.2	106.3	130.1	115.6

Source: Authors' calculations based on the National Accounts, Economic and Social Research Institute, Cabinet Office, Government of Japan, and the "Preliminary Estimate of Quarterly GDP (Second Preliminary Estimate) for Q3 2025"

## 2. Japanese Economic Outlook: FY2025–2027

### (1) Assumptions for Exogenous Variables

Let us first examine the assumptions regarding domestic policy (exogenous variables). Real public fixed capital formation declined by -1.1% QoQ in the July–September quarter of 2025, marking its first decrease in two quarters (April–June quarter: +0.0%). According to the General Construction Statistics (progressive basis) published by the Ministry of Land, Infrastructure, Transport and Tourism, public construction (nominal, seasonally adjusted) in the July–September quarter declined by -0.3% QoQ, also recording its first decrease in two quarters (April–June quarter: +5.0%). Reflecting these recent developments, the growth rate of real public fixed capital formation is assumed to be -1.4% in FY2025, +0.5% in FY2026, and +1.6% in FY2027.

Real government final consumption expenditure increased by +0.2% QoQ in

the July–September quarter, marking its second consecutive quarter of growth (April–June quarter: +0.3%). Reflecting these recent trends, the growth rate of real government final consumption expenditure is assumed to be +0.4% in FY2025, +0.7% in FY2026, and +0.7% in FY2027.

Considerable attention is being focused on the economic policies of the new Takaichi administration, which are intended to address both short-term priorities and medium- to long-term challenges. Among the highest-priority policy measures, short-term initiatives include the abolition of the provisional gasoline tax rate and support measures for electricity and gas charges during the winter season. In addition, the administration has set out longer-term policy frameworks, covering 17 strategic fields as well as eight cross-sectoral challenges. In the present forecast, however, only short-term policy measures are taken into account.

Among external conditions (exogenous variables), key assumptions concern crude oil prices, global trade, and the exchange rate. In the present forecast, the crude oil price—defined as the average of WTI, Dubai, and North Sea Brent—is projected at USD \$65.30 per barrel in the January–March quarter of 2026, USD \$60.67 in the January–March quarter of 2027, and USD \$60.67 in the January–March quarter of 2028. On an annual average basis, the price is assumed to be USD \$63.52 in FY2025, USD \$60.22 in FY2026, and USD \$60.67 in FY2027. Compared with the previous forecast, these assumptions represent downward revisions of approximately USD -\$2.9 for FY2025 and around USD -\$6.7 for FY2026.

With regard to the outlook for real global trade, the present forecast is based on the assessment presented in the IMF’s World Economic Outlook, October 2025.

At the December FOMC meeting, the Federal Reserve Board (FRB) lowered the policy interest rate by 25 basis points, setting the target range at 3.75–4.00%, marking the third consecutive rate cut. Looking ahead, the present forecast assumes two rate cuts during 2026 and around three cuts over the entire forecast period. By contrast, the Bank of Japan (BOJ) terminated its negative interest rate policy on March 19, 2024, implementing its first rate hike in 17 years. It subsequently raised the policy rate to 0.25% on July 31, to 0.50% on January 24, 2025, and further to 0.75% on December 19, bringing the policy rate to its highest level in approximately 30 years, since 1995. As real interest rates remain substantially negative even after these rate hikes, the BOJ has indicated that, provided its outlook is realized, it will continue to raise the policy interest rate. Looking ahead, the present forecast assumes additional rate hikes in December 2026 and September 2027. Although the depreciation of the yen accelerated again from April–June 2025 onward, the present forecast assumes that the yen will gradually appreciate in 2026, in light of the divergence in monetary policy stances between Japan and the

United States. Accordingly, the exchange rate is assumed to average 149.3 yen per U.S. dollar in FY2025, 146.0 yen in FY2026, and 139.9 yen in FY2027. Compared with the previous forecast, these assumptions represent downward revisions to the value of the yen (i.e., yen depreciation) of approximately 0.7 yen for FY2025 and 1.2 yen for FY2026, respectively.

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## (2) Forecast Results: Real GDP Growth

In this forecast, the second preliminary estimate of GDP for July–September 2025 has been incorporated. Reflecting revised assumptions for exogenous variables, including fiscal and monetary policies as well as external economic conditions, the outlook for the Japanese economy in FY2025–FY2026 has been updated, and a new forecast for FY2027 has been added. As a result, real GDP growth is projected at +0.9% in FY2025, +0.9% in FY2026, and +1.2% in FY2027 (Table 3-2-3). On a calendar-year basis, real GDP growth is likewise forecast at +0.9% in 2025, +0.9% in 2026, and +1.2% in 2027.

Looking at the contributions to forecast real GDP growth by major component, in FY2025, private demand is expected to contribute +1.0 %pt and public demand +0.0 %pt, thereby supporting overall growth, while net exports are projected to make a marginally negative contribution (-0.0 %pt). In FY2026, private demand is forecast to contribute +0.8 %pt, public demand +0.2 %pt, and net exports -0.1 %pt. In FY2027, the respective contributions are projected at +1.1 %pt for private demand, +0.2 %pt for public demand, and -0.1 %pt for net exports. Overall, private demand is expected to remain the main driver of Japan's economic growth over FY2025–2027, while net exports are unlikely to contribute meaningfully, as the impact of changes in U.S. tariff policy is expected to persist (Figure 3-2-3).

Examining the contributions of private demand by component, in FY2025, real private final consumption expenditure is projected to contribute +0.5 %pt, real private residential investment -0.1 %pt, real private non-residential investment +0.3 %pt, and real private inventories changes +0.2 %pt. With the exception of private residential investment, all components are expected to make positive contributions to growth. In FY2026, real private final consumption expenditure is forecast to contribute +0.4 %pt, real private residential investment +0.0 %pt, real private non-residential investment +0.4 %pt, and real private inventories changes -0.1 %pt. In this year, all components except inventory investment are expected to contribute positively.

In FY2027, real private final consumption expenditure is projected to contribute +0.6 %pt, real private residential investment +0.0 %pt, real private non-residential investment +0.5 %, and real private inventories changes +0.0 %pt, with all components making positive contributions to growth (Figure 3-2-4). As consumer price

Table 3-2-3 Summary of Forecast Results

	2024	2025	2026	2027
Real GDP (%)	0.5	0.9	0.9	1.2
Private demand (contribution)	0.4	1.0	0.8	1.1
Private final consumption expenditure (%)	0.2	1.1	0.8	1.1
Private residential investment (%)	-0.7	-3.2	0.8	0.6
Private non-residential investment (%)	0.9	1.8	2.1	2.8
Private inventory changes (contribution)	0.1	0.2	-0.1	0.0
Public demand (contribution)	0.5	0.0	0.2	0.2
Government final consumption expenditure (%)	2.3	0.4	0.7	0.7
Public investment expenditure (%)	0.1	-1.4	0.5	1.6
Public inventory changes (contribution)	0.0	0.0	0.0	0.0
External demand (contribution)	-0.4	0.0	-0.1	-0.1
Exports of goods and services (%)	1.7	2.1	0.8	2.1
Imports of goods and services (%)	3.3	2.3	1.3	2.9
Nominal GDP (%)	3.7	4.2	2.3	2.8
GDP deflator (%)	3.2	3.2	1.4	1.6
Domestic corporate price index (%)	3.4	2.6	1.0	0.6
Core consumer price index (%)	2.6	2.8	1.9	1.8
Industrial production index (%)	-1.4	0.7	1.3	1.3
New housing starts (%)	2.0	-14.0	9.3	1.7
Unemployment rate (%)	2.5	2.6	2.6	2.5
Current account balance (JPY trillion)	29.5	33.6	34.2	36.1
% of nominal GDP	4.6	5.0	5.0	5.1
Crude oil price (USD/barrel)	76.9	63.5	60.2	60.7
USD/JPY exchange rate	152.5	149.3	146.0	139.9
USA real GDP (% , calendar year)	2.8	2.0	1.9	2.0

Note: % change from the previous year, others are notes  
Source: Created by the author

inflation decelerates and real wages turn positive, the contribution of real private final consumption expenditure is expected to increase. At the same time, the contribution of private non-residential investment is projected to expand gradually, reflecting a turnaround in the global economy.

As a result, the recovery of the Japanese economy is expected to accelerate from FY2026 through FY2027.

Looking at real GDP (actual and projected) on a quarterly basis, growth turned negative in the July–September quarter of 2025 for the first time in six quarters. However, on average, the second half of FY2025 is expected to see a modest recovery. From FY2026 through FY2027, the Japanese economy is projected to continue expanding at a pace above its potential growth rate (Figure 3-2-5).

Compared with the baseline forecast above, two downside risks are

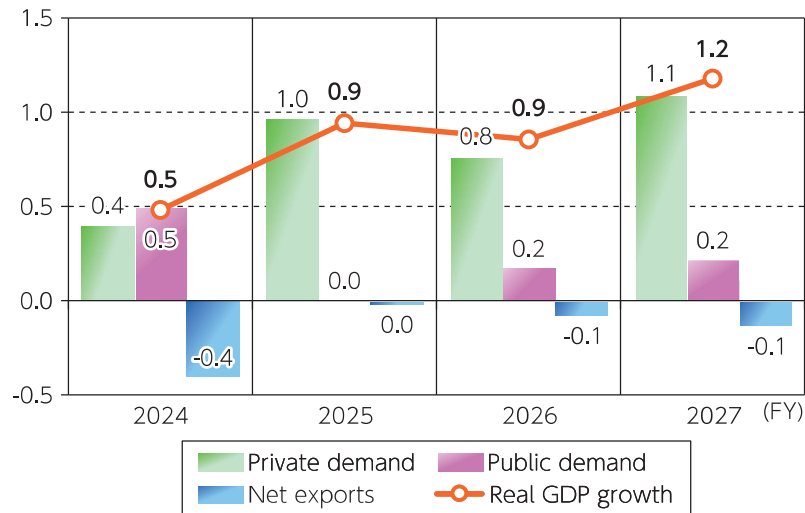


Figure 3-2-3

Real GDP Growth Rate and Contribution by Item (Units: QoQ %, %pt)

Source: Created by the author

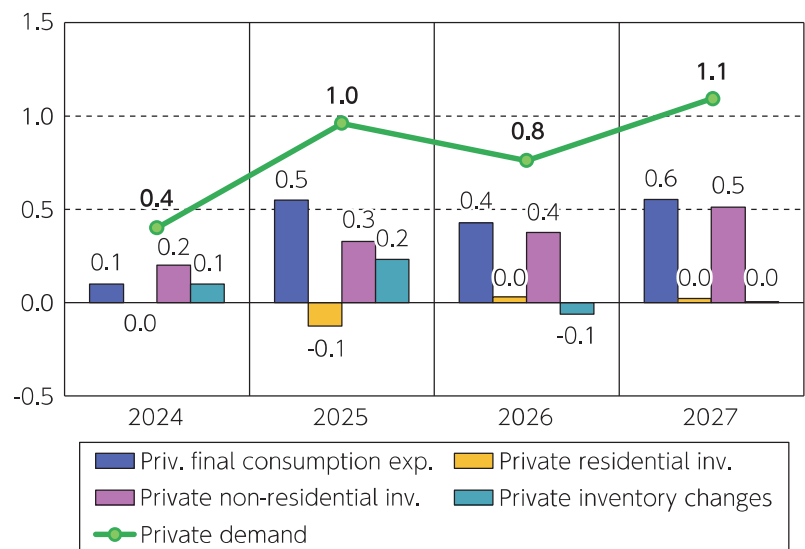
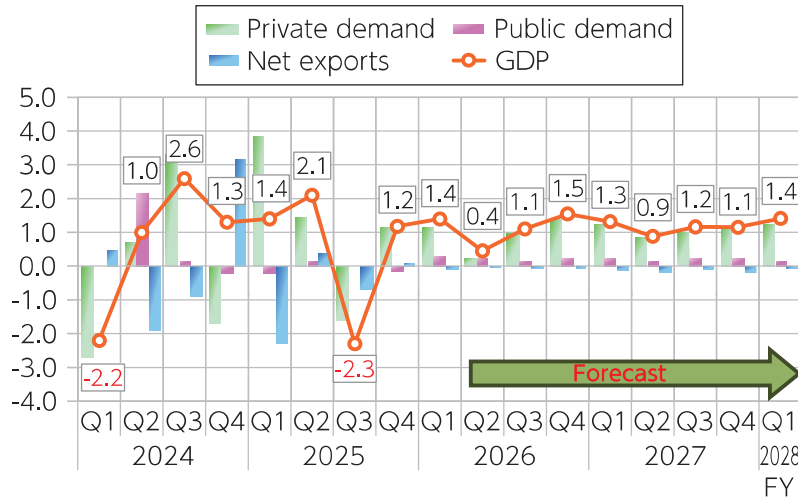


Figure 3-2-4

Contributions to real GDP growth by the components of private demand (Units: YoY %, %pt)

Source: Created by the author

identified. The first is the negative impact of the recent deterioration in Japan–China relations on exports, in particular on service exports driven by inbound tourism demand (see Box). The second is the adverse effect of a decline or correction in U.S. equity prices—so far supported by strong AI- and semiconductor-related demand (see Figure 3-2-2)—on global trade and private business investment. While these factors represent new sources of concern for Japan’s economic recovery, there is also growing attention and expectations surrounding the economic policies of the new cabinet, designed with both short-term stabilization and medium- to long-term growth in mind.



**Figure 3-2-5** Quarterly GDP: Actual and Forecast: QoQ, Annualized Rate (%)

Note: Actual figures up to the July-September quarter of 2025; forecast figures thereafter.  
 Source: Created by the author

### Box: The Impact of Deteriorating Japan–China Relations on Inbound Tourism Demand

This box examines the first of the two identified risks: the negative impact of the recent deterioration in Japan–China relations on inbound tourism demand (service exports).

According to the Japan National Tourism Organization (JNTO), the estimated number of inbound foreign visitors in October reached 3.896 million, the highest level ever recorded for the month of October. This represents an increase of +17.6% YoY, marking the third consecutive month of double-digit growth. Supported in part by the Osaka–Kansai Expo, inbound visitor numbers in 2025 are expected to exceed 40 million. In November, following Prime Minister Takaichi’s parliamentary remarks concerning a potential conflict over Taiwan, diplomatic tensions intensified. In response, China warned its citizens against traveling to Japan and suspended the resumption of Japanese seafood imports. Such a deterioration in diplomatic relations is expected to have significant adverse effects on both service and goods exports (see Inada et al., 2025, *Inbound Tourism: Mechanisms for Sustainable Development*, Chapter 1).

The economic impact of deteriorating Japan–China relations can be estimated using the following formula:

Economic impact=

Average spending per inbound visitor × Decline in the number of inbound visitors

As of January–September 2025, the average spending per Chinese visitor was approximately 239,000 yen. The key uncertainty lies in the decline in

the number of Chinese visitors. This decline is determined by multiplying the monthly decrease in visitors by the number of affected months. Historical cases provide useful reference points for estimating the monthly decline rate and duration of impact. For example, following the nationalization of the Senkaku Islands in September 2012, the YoY decline in Chinese visitors to Japan persisted for one year from October 2012. Comparing January–September 2013 with the same period in 2012, the number of Chinese visitors fell by -20.5%.

Looking at the share of inbound visitors, in the cumulative period from January to October 2025, China accounted for the largest share at 23.1%, followed by South Korea (21.6%), Taiwan (15.8%), the U.S. (7.7%), and Hong Kong (5.7%). The combined share of China and Hong Kong is just under 30%, indicating their substantial potential impact. According to the Inbound Consumption Trend Survey, total spending by inbound visitors in 2024 amounted to 8.1 trillion yen, making it the second-largest source of foreign revenue after automobile exports. Spending by Chinese and Hong Kong visitors totaled 2.4 trillion yen, highlighting the magnitude of their potential impact.

At present, the magnitude of the decline in inbound visitors remains highly uncertain. To avoid speculative assumptions, this box does not provide a quantitative estimate of the impact, but rather clarifies the approach for considering potential effects.

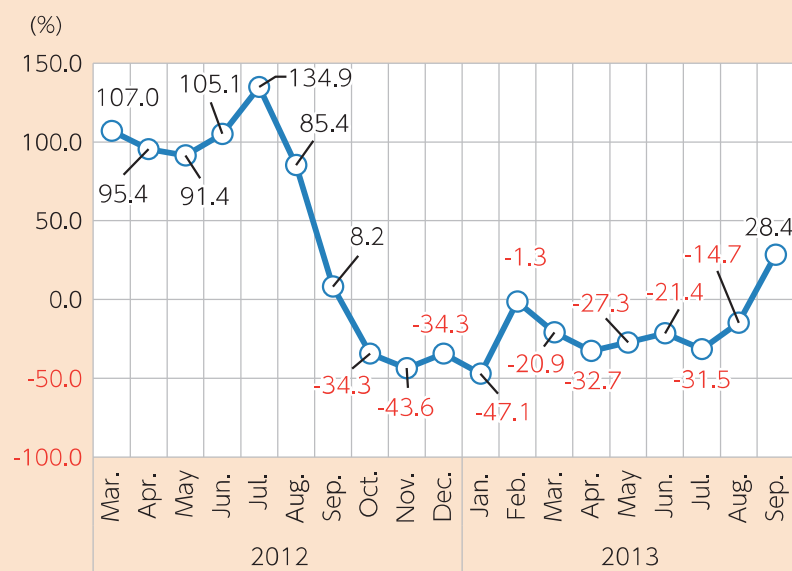


Figure 3-2-6

**Growth Trend in Chinese Visitors to Japan: YoY Comparison  
March 2012 to September 2013**

Source: Compiled by the author from the Japan National Tourism Organization's "Inbound Visitor Statistics"

### (3) Household Sector: Real Wages Expected to Increase Moderately in FY2026, Driving Recovery in Private Final Consumption

According to the Ministry of Internal Affairs and Communications' Real Total Consumption Trend Index (seasonally adjusted: 2020=100), a demand-side indicator of household consumption, consumption in October 2025 fell by -0.3% MoM, marking the first decline in 19 months. Compared with the average for July–September 2025, October consumption declined by -0.2% (July–September quarter: +0.3% QoQ).

According to the Ministry of Health, Labour and Welfare's Monthly Labour Survey (preliminary results, total for surveyed industries, establishments with 5 or more employees), total cash earnings in October 2025 increased by +2.6% YoY, marking the 46th consecutive month of positive growth. Real total cash earnings—calculated by deflating total cash earnings by the overall Consumer Price Index—declined by -0.4% YoY, registering a decrease for the third consecutive month.

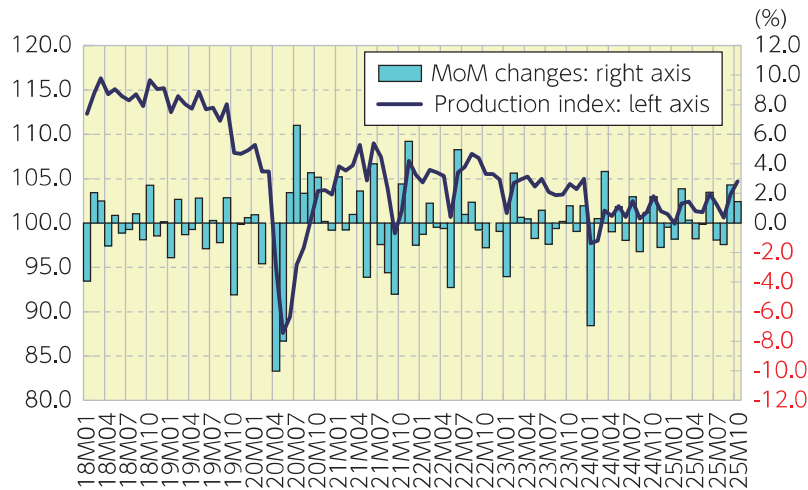
With the slowdown in consumer price inflation in 2026, real wages are expected to turn to moderate growth. In this forecast, private final consumption expenditure is projected to increase by +1.1% YoY in FY2025, +0.8% in FY2026, and +1.1% in FY2027.

According to the Ministry of Land, Infrastructure, Transport and Tourism, the planned construction expenditure (1 × residential construction + 0.7 × combined residential-industrial construction) which is a good indicator of private residential investment on a GDP basis, increased by +8.6% YoY in October 2025, marking the first increase in seven months. The seasonally adjusted value (APIR estimate) rose by +6.7% MoM, representing the second consecutive monthly increase. As a result, October planned construction expenditure were +12.9% higher than the July–September average (July–September quarter: +19.3% QoQ).

Given that significant improvement in the income environment is unlikely, real private residential investment is expected to remain sluggish in FY2025, declining by -3.2% YoY, before recovering modestly by +0.8% in FY2026 and +0.6% in FY2027.

### (4) Corporate Sector: Manufacturing Production Shows Fluctuations, While Service Activity Recovers Gradually

According to trends in the Indices of Industrial Production (final figures) released by the Ministry of Economy, Trade and Industry, the index of industrial production (seasonally adjusted) for October increased by +1.5% MoM in the final figures, marking the second consecutive monthly rise (Figure 3-2-7). As a result,



**Figure 3-2-7** Indices of Industrial Production (2020=100, seasonally adjusted)

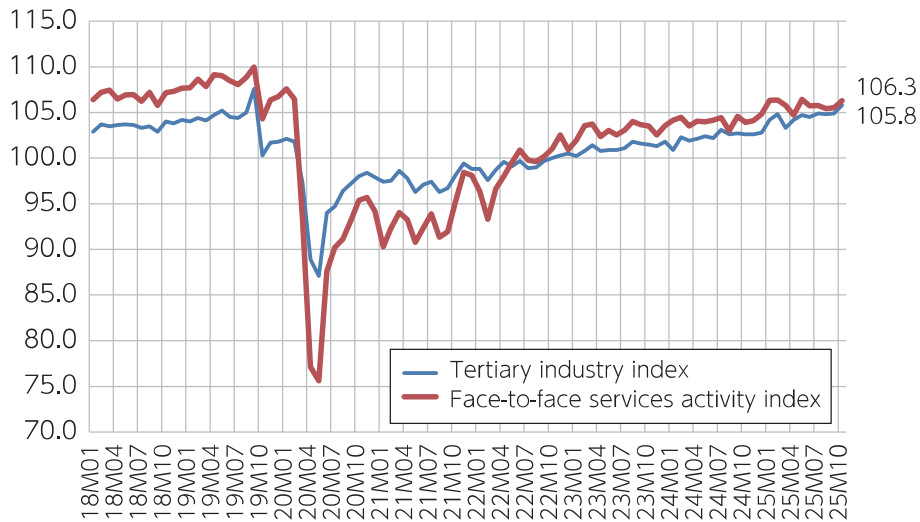
Source: Ministry of Economy, Trade and Industry, "Indices of Industrial Production"

the index for October rose by +2.7% compared with the July–September average (July–September quarter: 0.0%). METI left its assessment of the underlying trend in production for October unchanged from the previous month, describing it as “up and down”. Manufacturing output in November is projected to decline by -1.2% MoM, followed by a further decrease of -2.0% in December, with production cuts expected in both months. If these projections materialize, production in the October–December quarter is expected to increase by +1.2% QoQ.

Reflecting these developments, the index of industrial production is projected to rise by +0.7% YoY in FY2025, followed by growth of +1.3% in FY2026 and +1.3% in FY2027.

The Tertiary Industry Activity Index (seasonally adjusted) for October increased by +0.9% MoM, marking the second consecutive monthly rise. In October, the index rose by +0.9% compared with the July–September average (July–September quarter: +0.4% QoQ). METI left its assessment of the underlying trend for October unchanged from the previous month, maintaining the view that “although some weakness can be observed, a movement toward recovery is under way.” The Face-to-Face Services Activity Index (seasonally adjusted) for October increased by +0.7% MoM, also marking the second consecutive monthly increase (Figure 3-2-8). As a result, the index for October rose by +0.7% compared with the July–September average (July–September quarter: -0.0%).

According to the Quarterly Financial Statements Statistics of Corporations by Industry for the July–September quarter of 2025 released by the Ministry of Finance, ordinary profits on an all-industry basis (seasonally adjusted, excluding finance and insurance) increased by +3.3% QoQ, marking the second consecutive quarterly increase. Ordinary profits in the manufacturing sector rose by

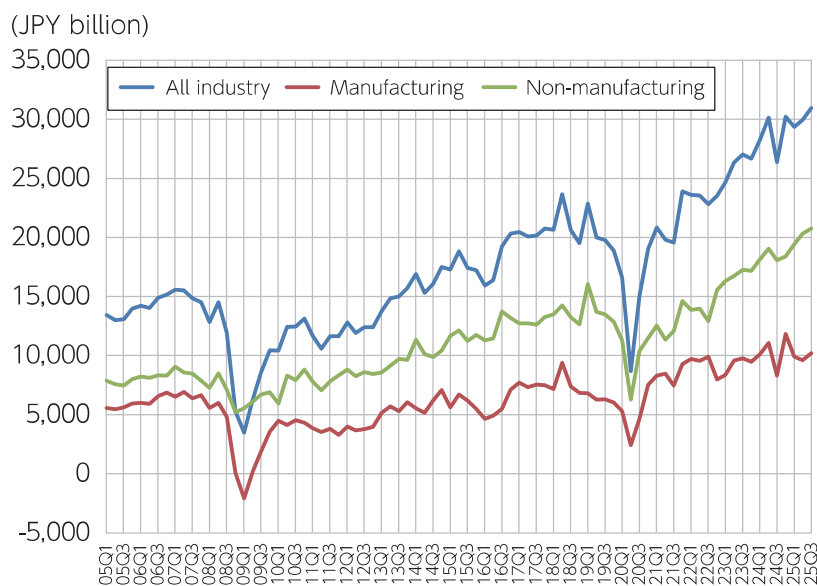


**Figure 3-2-8** Face-to-face Services vs. Tertiary Industry Activity Index (Seasonally adjusted, 2019-20=100)

Note: The face-to-face service industry index is the weighted average of transportation, postal services, lodging, food and beverage services, Living-related and personal services, entertainment, educational support services, and healthcare/welfare: 2019-2020 average = 100.

Source: Ministry of Economy, Trade and Industry, 'Tertiary Industry Activity Index'

+5.9% QoQ, recording the first increase in three quarters, while those in the non-manufacturing sector increased by +2.1% QoQ, extending growth for the fourth consecutive quarter. Corporate profits remain at a high level (Figure 3-2-9). Centered on investment aimed at addressing labor shortages and promoting digital transformation (DX), the potential for expansion remains strong, and the recent signs of easing uncertainty stemming from Trump tariffs support expectations for the continued resilience of private non-residential capital investment.



**Figure 3-2-9** Ordinary Profit by Sector (Seasonally adjusted)

Source: Ministry of Finance, "Quarterly Survey of Corporate Business Enterprises (July-September 2025)"

According to the Cabinet Office, core machinery orders (private-sector demand excluding ships and electric power; seasonally adjusted), which serve as a leading indicator of private capital investment, increased by +7.0% MoM in October, marking the second consecutive monthly rise. As a result, orders in October rose by +9.7% compared with the July–September average (July–September quarter: -2.1% QoQ). The Cabinet Office upgraded its underlying assessment of machinery orders in October to “showing signs of a pickup,” from the previous month’s assessment that “the pickup was showing signs of stalling.”

Looking at investment-related indicators released by the Ministry of Economy, Trade and Industry, the capital goods shipments index (final figures; seasonally adjusted) for October increased by +2.2% MoM, marking the third consecutive monthly rise. As a result, the index for October rose by +3.9% compared with the July–September average (July–September quarter: -4.6% QoQ).

Taking into account recent developments in orders and shipments, real private non-residential investment is projected to recover, increasing by +1.8% YoY in FY2025, followed by growth of +2.1% in FY2026 and +2.8% in FY2027.

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### **(5) External Sector: The Impact of the Deterioration in Japan–China Relations on the Recovery of the Two Types of Exports**

According to the preliminary Trade Statistics released by the Ministry of Finance, the trade balance in November recorded a surplus of 322.3 billion yen, returning to surplus for the first time in five months, with the balance improving by 443.0 billion yen compared with the same month a year earlier. On a seasonally adjusted basis, the trade balance posted a surplus of 62.9 billion yen, marking the second consecutive month of surplus, although the size of the surplus narrowed by -15.0% from the previous month. As a result, the average trade balance for October–November improved by 270.9 billion yen compared with the July–September average (July–September quarter: -18.9% QoQ).

Exports (seasonally adjusted) increased by +3.4% MoM, marking the fourth consecutive monthly rise. Imports (seasonally adjusted) rose by +3.5% MoM, recording the first increase in two months. Comparing the October–November average with the July–September average, exports increased by +3.4% and imports by +0.4%.

On a volume basis (seasonally adjusted; APIR estimates), the export volume index for November increased by +6.6% MoM, recording the first rise in two months. The import volume index also rose by +2.0% MoM, also marking the first increase in two months. Comparing the October–November average with the July–September average, the export volume index increased by +3.4% and the import volume index by +0.4%. As a result, the contribution of net real exports of goods to GDP growth

was positive on average over the October–November period.

Looking at regional developments for November (seasonally adjusted; APIR estimates), exports to Asia declined by -1.0% MoM, exports to China fell by -12.9%, while exports to the United States increased by +8.1% and exports to the EU rose by +5.5%. Comparing the October–November average with the July–September average, exports to Asia increased by +1.4%, those to China declined by -1.9%, exports to the U.S. rose by +14.0%, and exports to the EU increased by +4.1%, with all regions except China recording positive growth. By contrast, imports from Asia in November declined by -3.6% MoM, imports from China fell by -2.4%, imports from the U.S. decreased by -14.7%, while imports from the EU increased by +1.2%. Comparing the October–November average with the July–September average, imports from Asia declined by -1.5%, imports from China increased by +0.6%, imports from the U.S. rose by +5.6%, and imports from the EU fell by -13.0%. Imports from China and the U.S. recorded increases, while those from Asia and the EU declined (Figure 3-2-10).

Taking into account these recent developments, real exports of goods and services are projected to increase by +2.1% YoY in FY2025, followed by growth of +0.8% in FY2026 and +2.1% in FY2027. By contrast, real imports of goods and services are projected to rise by +2.3% in FY2025, +1.3% in FY2026, and +2.9% in FY2027. Compared with the previous forecast, projections for real exports of goods and services in FY2025–2026 have been revised downward to reflect the recent stagnation in exports. Projections for real imports, meanwhile, have been revised slightly upward for FY2025–2026 in light of a reassessment of the outlook for domestic demand.

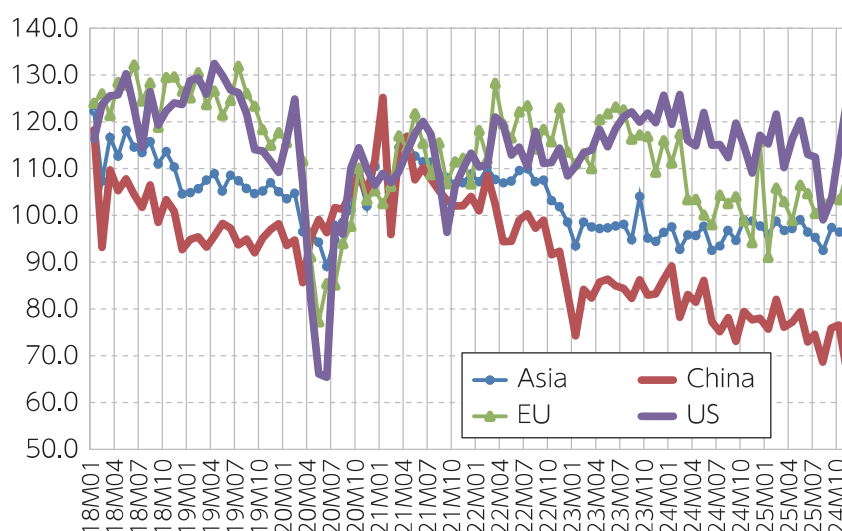


Figure 3-2-10 Export Volume Index by Region (2020=100)

Source: Ministry of Finance, "Trade Statistics," seasonally adjusted values are APIR estimates

In value terms, the trade deficit is expected to show a narrowing trend in FY2025, reflecting a decline in crude oil prices. At the same time, however, signs have emerged that the expansion of robust inbound tourism demand is losing momentum. The recent deterioration in Japan–China relations has raised the possibility of a significant negative impact on the travel balance. Meanwhile, as the digital deficit continues to expand steadily, improvement in the services balance deficit is expected to be slow. At the same time, given the persistence of a high level of primary income balance, the current account surplus is projected to amount to 33.6 trillion yen in FY2025, 34.2 trillion yen in FY2026, and 36.1 trillion yen in FY2027. For the impact of the recent deterioration in Japan–China relations, see the Box above.

### (6) Price Developments: Consumer inflation is expected to fall below 3% in FY2026, reflecting the effects of declining import prices.

According to the Bank of Japan, the Domestic Corporate Goods Price Index (2020 average = 100) rose by +0.3% MoM in November, marking the third consecutive monthly increase. In terms of contributions to the MoM change by category, electricity, city gas and water supply, non-ferrous metals, food and beverages, agricultural, forestry and fishery products, and scrap materials contributed positively to the domestic corporate goods price index. By contrast, petroleum and coal products exerted a downward pressure on the index. On a year-on-year basis, the domestic corporate goods price index increased by +2.7%, remaining positive for the 57th consecutive month. As a result, the inflation rate stayed in the upper 2% range for the sixth consecutive month (Figure 3-2-11).

The exchange rate in November stood at 155.12 yen per dollar, representing

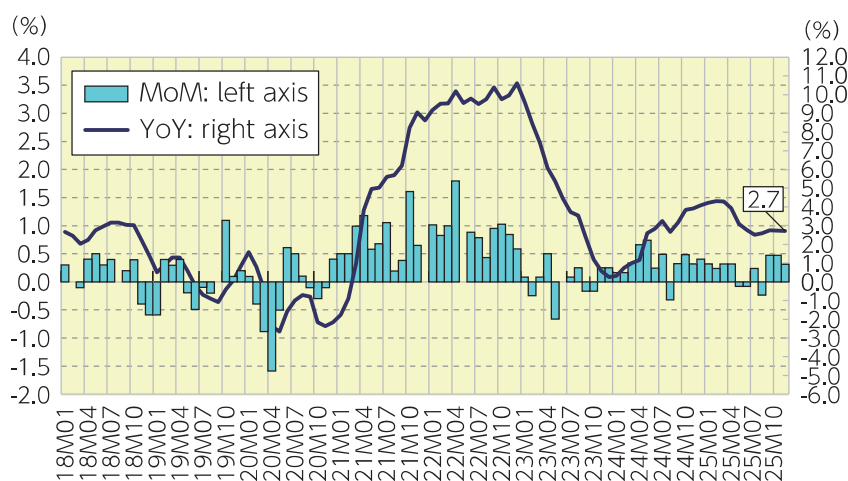


Figure 3-2-11

Changes in Domestic Corporate Goods Price Index (2020=100, MoM and YoY)

Source: Bank of Japan, "Domestic corporate goods price index"

a +2.5% depreciation of the yen from the previous month and marking the fifth consecutive month of yen depreciation. On a year-on-year basis, the yen depreciated by +0.9%, extending the depreciation to four consecutive months. As a result, the yen-based Export Price Index rose by +2.4% YoY, increasing for the third consecutive month. By contrast, the yen-based Import Price Index declined by 1.8% YoY, marking the tenth consecutive month of decline. Consequently, the Terms of Trade Index (export price index/import price index\* 100) increased by +0.4 points from the previous month, improving for the third consecutive month. Compared with the same month of the previous year, the index rose by +3.6 points, registering improvement for the 32nd consecutive month (Figure 3-2-12).

According to the Ministry of Internal Affairs and Communications, the National Consumer Price Index (all items; 2020 average = 100) in November rose by +2.9% YoY, marking an increase for the 51st consecutive month. The core index, which excludes volatile fresh food prices, increased by +3.0% YoY, also registering its 51st consecutive month of increase, with the inflation rate returning to the 3% range for the second consecutive month. Meanwhile, the core-core index, which excludes both fresh food and energy, rose by +3.0% YoY, extending its increase to 44 consecutive months (Figure 3-2-13).

Looking at item-by-item developments in the headline CPI for November, energy prices rose by +2.5% YoY, marking an increase for the third consecutive month. Their contribution to the overall index was +0.19%. Within energy, electricity charges increased by +4.9% YoY, rising for the third consecutive month. City gas charges rose by +0.9% YoY, also marking the third consecutive month

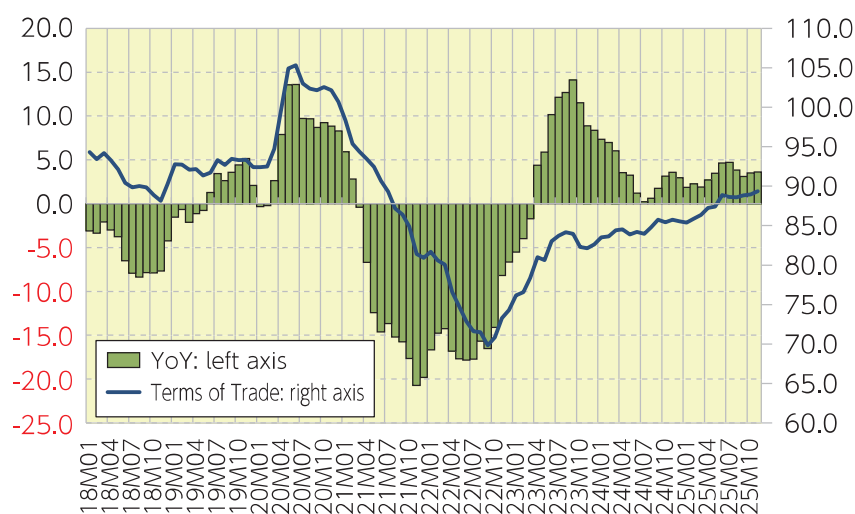


Figure 3-2-12 Terms of Trade (2020=100, Unit %pt YoY)

Source: Authors' calculations based on Bank of Japan, "Domestic Corporate Goods Price Index"

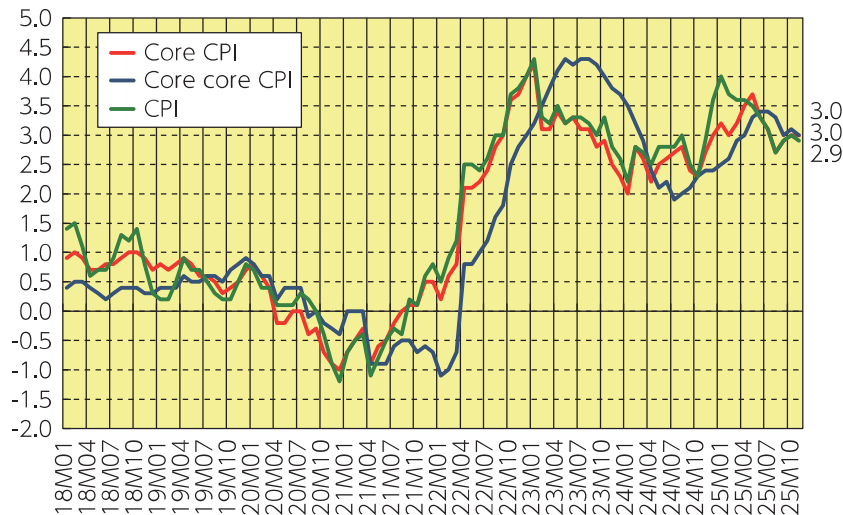


Figure 3-2-13

Changes in National Consumer Price Index (2020=100, Unit % YoY)

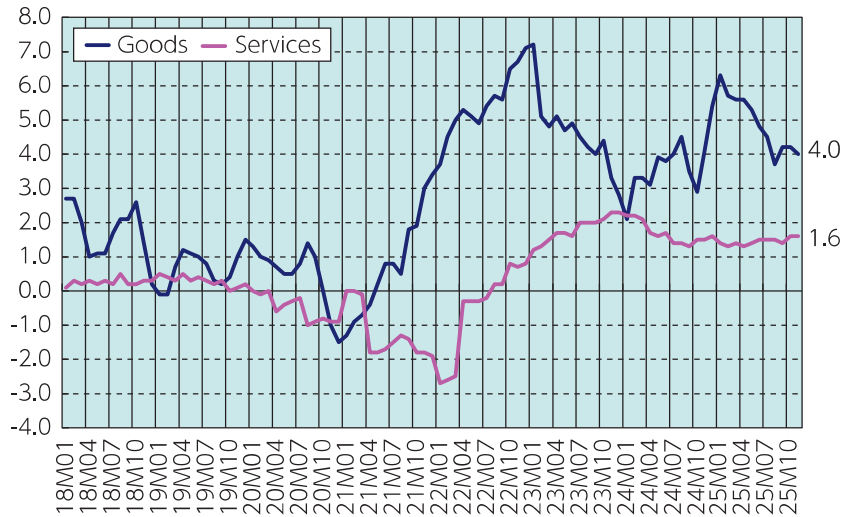
Source: Ministry of Internal Affairs and Communications, "National Consumer Price Index"

of increase. By contrast, gasoline prices declined by -0.9% YoY, falling for the first time in four months.

Non-energy items increased by +3.0% YoY, marking an increase for the 44th consecutive month. Their contribution amounted to +2.71%. Within this category, food excluding fresh food rose by +7.0% YoY, extending its increase to 53 consecutive months. Although the inflation rate decelerated from the previous month for the fourth consecutive month, it remains at an elevated level. The contribution of this category was +1.69%. Within food excluding fresh food, rice prices increased by +37.1% YoY, marking an increase for the 36th consecutive month; however, the rate of increase has decelerated for six consecutive months.

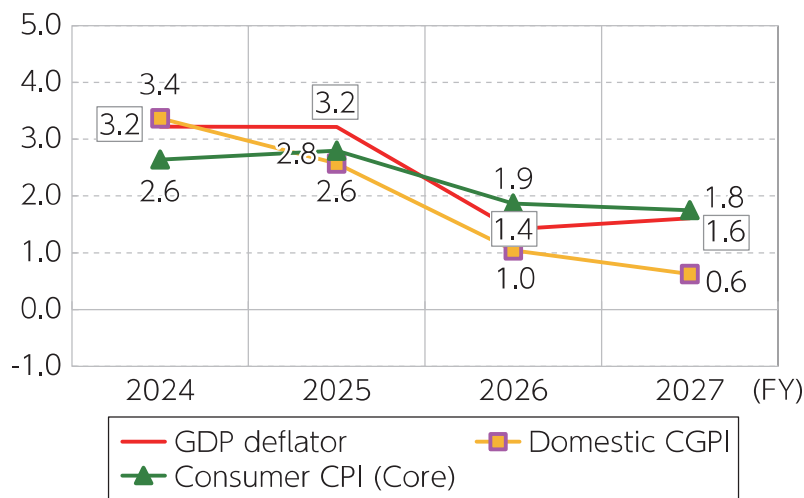
From the perspective of the goods–services classification, goods prices rose by +4.0% YoY, marking an increase for the 55th consecutive month. Their contribution was +2.17%. Services prices increased by +1.6% YoY, extending their rise to 40 consecutive months, with a contribution of +0.73%. Within service-related expenditures, accommodation charges rose by +9.2% YoY, marking an increase for the 32nd consecutive month, while communication charges increased by +14.5% YoY, extending their rise to 12 consecutive months (Figure 3-2-14).

Taking recent developments into account, the domestic corporate goods index is projected to increase by +2.6% in FY2025, +1.0% in FY2026, and +0.6% in FY2027. The inflation rate of the Core CPI is forecast at +2.8% in FY2025, +1.9% in FY2026, and +1.8% in FY2027. Reflecting the abolition of the provisional gasoline tax and support measures for electricity and city gas prices, the inflation rate is expected to fall below 2% in FY2026. The GDP deflator, which is the headline indicator, is projected to increase by +3.2% in FY2025, +1.4% in FY2026, and +1.6% in FY2027 (Figure 3-2-15).



**Figure 3-2-14** Changes in National Consumer Price Index by Category (Unit: % YoY)

Source: Ministry of Internal Affairs and Communications, "National Consumer Price Index"



**Figure 3-2-15** Inflation Trend (YoY, %)

Source: Created by the author

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Inada, Yoshihisa; Tada, Noriko; Nomura, Ryosuke; and Matsubayashi, Yoichi (2025). *Inbound Tourism: The Mechanisms of Sustainable Development*. Chuo Keizai-sha, (September 19, 2025).