Not to be released until 2:00 p.m.
Japan Standard Time on
Friday, May 2, 2025.

日本銀行
BANK OF JAPAN

Outlook for Economic Activity and Prices

April 2025

(English translation prepared by the Bank's staff based on the Japanese original)

Outlook for Economic Activity and Prices (April 2025)

The Bank's View[1]

Summary

- Japan's economic growth is likely to moderate, as trade and other policies in each jurisdiction lead to a slowdown in overseas economies and to a decline in domestic corporate profits and other factors, although factors such as accommodative financial conditions are expected to provide support. Thereafter, Japan's economic growth rate is likely to rise, with overseas economies returning to a moderate growth path.
- The year-on-year rate of increase in the consumer price index (CPI, all items less fresh food) is likely to be in the range of 2.0-2.5 percent for fiscal 2025, in the range of 1.5-2.0 percent for fiscal 2026, and at around 2 percent for fiscal 2027. The effects of the past rise in import prices and of the recent rise in food prices such as rice prices -- these factors have pushed up the inflation rate so far -- are expected to wane. Meanwhile, underlying CPI inflation is likely to be sluggish, mainly due to the deceleration in the economy. Thereafter, however, underlying CPI inflation is expected to increase gradually, since it is projected that a sense of labor shortage will grow as the economic growth rate rises, and that medium- to long-term inflation expectations will rise. In the second half of the projection period, underlying CPI inflation is likely to be at a level that is generally consistent with the price stability target.
- Comparing the projections through fiscal 2026 with those presented in the previous *Outlook for Economic Activity and Prices* (Outlook Report), the projected real GDP growth rate for fiscal 2024 is somewhat higher, but the projected growth rates for fiscal 2025 and 2026 are lower due to the effects of trade and other policies in each jurisdiction. The projected year-on-year rates of increase in the CPI (all items less fresh food) for fiscal 2025 and 2026 are lower, mainly reflecting the decline in crude oil prices and the downward revision of the GDP growth rates.
- There are various risks to the outlook. In particular, it is extremely uncertain how trade and other policies in each jurisdiction will evolve and how overseas economic activity and prices will react to them. It is therefore necessary to pay due attention to the impact of these developments on financial and foreign exchange markets and on Japan's economic activity and prices.
- With regard to the risk balance, risks to economic activity are skewed to the downside for fiscal 2025 and 2026. Risks to prices are also skewed to the downside for fiscal 2025 and 2026.

[1] "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on April 30 and May 1, 2025.

I. Current Situation of Economic Activity and Prices in Japan

Japan's economy has recovered moderately, although some weakness has been seen in part. Overseas economies have grown moderately on the whole, although some weakness has been seen in part, reflecting trade and other policies in each jurisdiction. Exports and industrial production have continued to be more or less flat as a trend, although there has been some front-loading due to the increase in U.S. tariffs. Corporate profits have been on an improving trend and business sentiment has stayed at a favorable level. In this situation, business fixed investment has been on a moderate increasing trend. Private consumption has maintained its moderate increasing trend against the background of an improvement in the employment and income situation, despite weakness in consumer sentiment due to the impact of price rises and other factors. Housing investment has been relatively weak. Public investment has been more or less flat. Financial conditions have been accommodative. On the price front, the year-on-year rate of increase in the CPI (all items less fresh food) has been in the range of 3.0-3.5 percent recently, as moves to pass on wage increases to selling prices have continued, and as there have been effects of the past rise in import prices and of the rise in food prices, such as rice prices. Inflation expectations have risen moderately.

II. Baseline Scenario of the Outlook for Economic Activity and Prices in Japan[2,3]

A. Baseline Scenario of the Outlook for Economic Activity

Japan's economic growth is likely to moderate, as trade and other policies in each jurisdiction lead to a slowdown in overseas economies and to a decline in domestic corporate profits and other factors, although factors such as accommodative financial conditions are expected to provide support.

Exports and production are likely to show some weakness, against the background of the slowdown in overseas economies. Reflecting these developments, corporate profits are also likely to decrease, while being at high levels. In this situation, the growth rate of business fixed investment is likely to decelerate, affected by the slowdown in overseas economies, although it is expected that investment to address labor shortages, digital-related investment, research and development (R&D) investment related to growth areas and decarbonization, and investment associated with strengthening supply chains

[2] There are extremely high uncertainties regarding the future course of trade and other policies in each jurisdiction and the impact of these policies on economic activity and prices at home and abroad. The baseline scenario in this Outlook Report is developed based on assumptions including the following: negotiations between jurisdictions will progress to some extent, and significant disruptions of global supply chains will be avoided. Attention is warranted on the possibility that the outlook for economic activity and prices could change considerably depending on the future course of the policies in each jurisdiction and the response of firms and households in these jurisdictions to the policies.

[3] Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

will continue and that accommodative financial conditions will provide support. Regarding the employment and income situation, despite the deceleration in the economy, labor market conditions are likely to remain tight, as it will become more difficult for labor supply of women and seniors to increase. Against this backdrop, the growth rate of nominal wages is likely to remain high for the time being, reflecting factors such as the outcome of this year's annual spring labor-management wage negotiations. Thereafter, nominal wages are highly likely to continue increasing, although the growth rate is likely to decelerate somewhat, affected by the decline in corporate profits. Although private consumption is expected to be affected by the price rises for the time being, it is projected to maintain its moderate increasing trend, mainly due to a continued rise in employee income. Private consumption is also projected to be underpinned by the government's initiatives such as the measures to reduce the household burden of higher gasoline prices and the tax reform in fiscal 2025. Meanwhile, public investment is expected to be more or less flat, and government consumption is expected to increase moderately in reflection of an uptrend in healthcare and nursing care expenditures.

Thereafter, Japan's economic growth rate is likely to rise, with overseas economies returning to a moderate growth path. Exports and production are likely to return to an uptrend. Corporate profits are likely to improve with an increase in domestic and external demand, and business fixed investment is likely to continue on an increasing trend, partly due to investment for capacity expansion to address the rise in demand. Looking at the employment and income situation, the growth rate of nominal wages is expected to accelerate again, with a growing sense of labor shortage, and private consumption is projected to increase moderately.

Comparing the projections through fiscal 2026 with those presented in the previous Outlook Report, the projected real GDP growth rate for fiscal 2024 is somewhat higher, mainly led by private consumption. The projected growth rates for fiscal 2025 and 2026 are lower due to the effects of trade and other policies in each jurisdiction.

Meanwhile, the potential growth rate is expected to rise moderately.[4] This is mainly because productivity is likely to increase due to advances in digitalization and investment in human capital, and because capital stock growth is projected to accelerate due to a rise in business fixed investment. Potential growth is likely to be supported by the government's various measures and other factors.

[4] Under a specific methodology, Japan's recent potential growth rate is estimated to be around 0.5 percent. However, the rate should be interpreted with considerable latitude. This is because the estimate is subject to change depending on the methodologies employed and could be revised as the sample period becomes longer over time. In addition, there are high uncertainties over how factors such as advances in digitalization will affect the trends in productivity or labor supply.

B. Baseline Scenario of the Outlook for Prices

The year-on-year rate of increase in the CPI (all items less fresh food) is likely to be in the range of 2.0-2.5 percent for fiscal 2025, in the range of 1.5-2.0 percent for fiscal 2026, and at around 2 percent for fiscal 2027. The effects of the past rise in import prices and of the recent rise in food prices such as rice prices -- these factors have pushed up the inflation rate so far -- are expected to wane. Meanwhile, underlying CPI inflation is likely to be sluggish, mainly due to the deceleration in the economy. Thereafter, however, underlying CPI inflation is expected to increase gradually, since it is projected that a sense of labor shortage will grow as the economic growth rate rises, and that medium- to long-term inflation expectations will rise. In the second half of the projection period, underlying CPI inflation is likely to be at a level that is generally consistent with the price stability target.

Comparing the projections through fiscal 2026 with those presented in the previous Outlook Report, the projected year-on-year rates of increase in the CPI (all items less fresh food) for fiscal 2025 and 2026 are lower, mainly reflecting the decline in crude oil prices and the downward revision of the GDP growth rates.

The outlook for the CPI (all items less fresh food) depends on the assumptions regarding crude oil prices and the government's measures. Crude oil prices are assumed to be more or less flat throughout the projection period with reference, for example, to developments in futures markets. Looking at the CPI (all items less fresh food and energy) -- which is not directly affected by fluctuations in energy prices -- the year-on-year rate of increase is likely to be temporarily below 2 percent because it is expected that the effects of the past rise in import prices and of the recent rise in food prices, such as rice prices, will gradually wane and that this CPI will be affected by factors such as the deceleration in the economy. Thereafter, however, the rate of increase in this CPI is likely to be at around 2 percent as the economic growth rate rises.

The main factors that determine underlying inflation are assessed as follows. The output gap, which captures the utilization of labor and capital, has followed an improving trend, albeit with fluctuations. Based on the aforementioned outlook for economic activity, it is likely that the gap will remain at around the current level, but will improve again toward the end of the projection period. Meanwhile, labor market conditions have tightened to a greater extent than can be explained by the changes in the output gap, partly due to a deceleration in the pace of increase in labor force participation of women and seniors. In this situation, upward pressure on wages and prices is likely to be stronger than suggested by the output gap, given that firms in many industries have started to face labor supply constraints.

Medium- to long-term inflation expectations have risen moderately. Regarding the outlook, although it is projected that firms will maintain their active wage- and price-setting behavior and will continue their moves to reflect higher costs -- including increased

personnel expenses and distribution costs -- in selling prices, inflation expectations are expected to be sluggish, mainly due to the deceleration in the economy. Thereafter, as the economic growth rate rises and labor market conditions tighten notably, it is expected that firm's active wage- and price-setting behavior will become more widespread, and that inflation expectations will rise moderately again.

III. Risks to Economic Activity and Prices

A. Risks to Economic Activity

Regarding the aforementioned baseline scenario of the outlook for economic activity, the main upside and downside risks that require attention are as follows.

The first is the evolving situation regarding trade and other policies in each jurisdiction and developments in overseas economic activity and prices under such a situation. The trade policy recently announced in each jurisdiction is likely to push down domestic and overseas economies through various channels. The introduction of wide-ranging tariffs is expected to impact global trade activity, and the heightened uncertainties regarding policies including tariffs are likely to have a large impact on business and household sentiment around the world and on global financial and capital markets. The impact that these policies have on domestic and overseas economies and the degree of the impact will depend largely on the future course of these policies, and therefore it is necessary to pay due attention to their developments. Meanwhile, depending on factors such as the course of the situation surrounding Ukraine and the Middle East, downward pressure on overseas economies could heighten. Regarding the Chinese economy, there remain high uncertainties surrounding the future pace of growth, including the effects of government policies, as adjustment pressure has continued in the real estate and labor markets. In addition, it is necessary to pay attention to how excessive supply capacity of some goods -- coupled with the effects of trade policies -- will affect global economic activity and prices.

The second risk is developments in import prices. Reflecting the aforementioned effects of trade and other policies in each jurisdiction, if disruptions in global logistics were to arise or moves to restructure supply chains were to take place and incur considerable costs, import prices could rise, and this could in turn push down domestic demand. In addition, attention continues to be warranted on the risk that prices of grains and other commodities will fluctuate significantly due to geopolitical factors, such as those concerning Ukraine and the Middle East. Furthermore, in the medium to long term, there are extremely high uncertainties surrounding, for example, efforts by countries around the world toward addressing climate change. Moreover, if import prices were to rise significantly, households' defensive attitudes toward spending could strengthen further,

and this could push down the economy. On the other hand, if import prices decline, the economy could deviate upward.

The third risk considered from a somewhat long-term perspective is the impact of various changes in the environment surrounding Japan on firms' and households' medium- to long-term growth expectations and on Japan's potential growth rate. It is expected that factors such as the experience of COVID-19, intensifying labor shortages, and progress on efforts with a view to decarbonization and on labor market reform will change Japan's economic structure and people's working styles. Intensifying labor shortages -- which are partly due to demographic changes -- could accelerate labor-saving investment, such as for digitalization. On the other hand, if such a substitution of labor with capital does not sufficiently progress, there is a risk that supply-side constraints in some industries will push down the growth rate. Furthermore, the trade policy recently announced in each jurisdiction could trigger a change in the trend of globalization, and depending on the future course of these policies, this change may accelerate.

B. Risks to Prices

If the aforementioned risks to economic activity materialize, prices also are likely to be affected. In addition, it is necessary to pay attention to the following two risks that are specific to prices.

The first is firms' wage- and price-setting behavior and its impact on inflation expectations. Firms' behavior has shifted more toward raising wages and prices, and it is expected in the baseline scenario that this trend will be maintained, despite the deceleration in the economy. However, a prolonged period of high uncertainties regarding trade and other policies in each jurisdiction could lead firms to focus more on cost cutting. As a result, moves to reflect price rises in wages could also weaken. On the other hand, moves to reflect wages in selling prices could strengthen to a greater extent than expected, and upward pressure on wages could intensify with growing expectations that labor market conditions will continue to be tight. In this situation, there is also a possibility that both wages and prices will deviate upward from the baseline scenario, accompanied by a rise in medium- to long-term inflation expectations. Meanwhile, with regard to the recent rise in food prices, such as rice prices, even when price rises themselves mainly result from weather conditions, attention is warranted on the possibility that these rises may induce second-round effects on underlying CPI inflation through changes in household sentiment and inflation expectations.

The second risk is future developments in foreign exchange rates and import prices, including international commodity prices, as well as the extent to which such developments will spread to domestic prices. This risk may lead prices to deviate either upward or downward from the baseline scenario. There are high uncertainties over the

outlook for the global economy, including the future course of trade and other policies in each jurisdiction, which could lead to a rise in import prices from the supply side or to significant fluctuations in foreign exchange rates and international commodity prices. In this regard, with firms' behavior shifting more toward raising wages and prices recently, exchange rate developments are, compared to the past, more likely to affect prices.

IV. Conduct of Monetary Policy

In the context of the price stability target, the Bank assesses the aforementioned economic and price situation from two perspectives and then outlines its thinking on the future conduct of monetary policy.[5]

The first perspective involves an examination of the baseline scenario of the outlook. The year-on-year rate of increase in the CPI is likely to be in the range of 2.0-2.5 percent for fiscal 2025, in the range of 1.5-2.0 percent for fiscal 2026, and at around 2 percent for fiscal 2027. Meanwhile, underlying CPI inflation is likely to be sluggish, mainly due to the deceleration in the economy. Thereafter, however, underlying CPI inflation is expected to increase gradually, since it is projected that a sense of labor shortage will grow as the economic growth rate rises, and that medium- to long-term inflation expectations will rise. In the second half of the projection period, underlying CPI inflation is likely to be at a level that is generally consistent with the price stability target.

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. There are various risks surrounding Japan's economic activity and prices. In particular, it is extremely uncertain how trade and other policies in each jurisdiction will evolve and how overseas economic activity and prices will react to them. It is therefore necessary to pay due attention to the impact of these developments on financial and foreign exchange markets and on Japan's economic activity and prices. With regard to the risk balance, risks to economic activity are skewed to the downside for fiscal 2025 and 2026. Risks to prices are also skewed to the downside for fiscal 2025 and 2026.

Examining risks on the financial side, overheating has generally not been seen in asset markets and financial institutions' credit activities, although attention continues to be warranted on the pace of increase in real estate prices. Japan's financial system has maintained stability on the whole. In addition, even in the case of an adjustment in the real economy at home and abroad and in global financial markets, the financial system is likely to remain highly robust on the whole, mainly because Japanese financial institutions have sufficient capital bases. In this regard, given the extremely high uncertainties regarding

[5] As for the examination from two perspectives in the context of the price stability target, see the Bank's statement released on January 22, 2013, entitled "The 'Price Stability Target' under the Framework for the Conduct of Monetary Policy."

trade and other policies in each jurisdiction, it is necessary to carefully monitor the impact these policies have on the financial system through various channels.[6]

As for the conduct of monetary policy, given that real interest rates are at significantly low levels, if the aforementioned outlook for economic activity and prices will be realized, the Bank, in accordance with improvement in economic activity and prices, will continue to raise the policy interest rate and adjust the degree of monetary accommodation. In this regard, considering the extremely high uncertainties regarding the future course of trade and other policies in each jurisdiction and the impact of these policies, it is important for the Bank to carefully examine factors such as developments in economic activity and prices as well as in financial markets at home and abroad, and judge whether the outlook will be realized, without any preconceptions. With the price stability target of 2 percent, the Bank will conduct monetary policy as appropriate, in response to developments in economic activity and prices as well as financial conditions, from the perspective of sustainable and stable achievement of the target.

[6] For details, see the Bank's *Financial System Report* (April 2025).

(Appendix)

Forecasts of the Majority of the Policy Board Members

y/y % chg.

	Real GDP	CPI (all items less fresh food)	(Reference) CPI (all items less fresh food and energy)
Fiscal 2024	+0.7 to +0.7 [+0.7]	+2.7	+2.3
Forecasts made in January 2025	+0.4 to +0.6 [+0.5]	+2.6 to +2.8 [+2.7]	+2.1 to +2.3 [+2.2]
Fiscal 2025	+0.4 to +0.6 [+0.5]	+2.0 to +2.3 [+2.2]	+2.2 to +2.4 [+2.3]
Forecasts made in January 2025	+0.9 to +1.1 [+1.1]	+2.2 to +2.6 [+2.4]	+2.0 to +2.3 [+2.1]
Fiscal 2026	+0.6 to +0.8 [+0.7]	+1.6 to +1.8 [+1.7]	+1.7 to +2.0 [+1.8]
Forecasts made in January 2025	+0.8 to +1.0 [+1.0]	+1.8 to +2.1 [+2.0]	+1.9 to +2.2 [+2.1]
Fiscal 2027	+0.8 to +1.0 [+1.0]	+1.8 to +2.0 [+1.9]	+1.9 to +2.1 [+2.0]

Notes: 1. Figures in brackets indicate the medians of the Policy Board members' forecasts (point estimates).

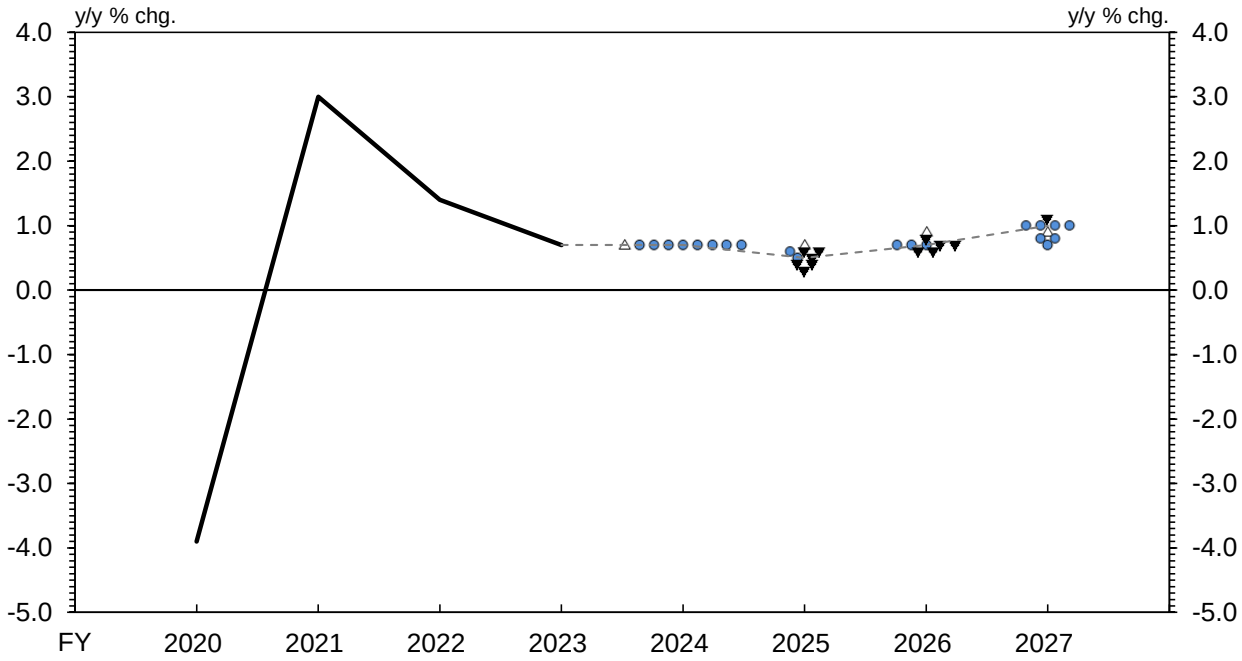
2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which they attach the highest probability of realization. These forecasts are then shown as a range, with the highest figure and the lowest figure excluded. The range does not indicate the forecast errors.

3. Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

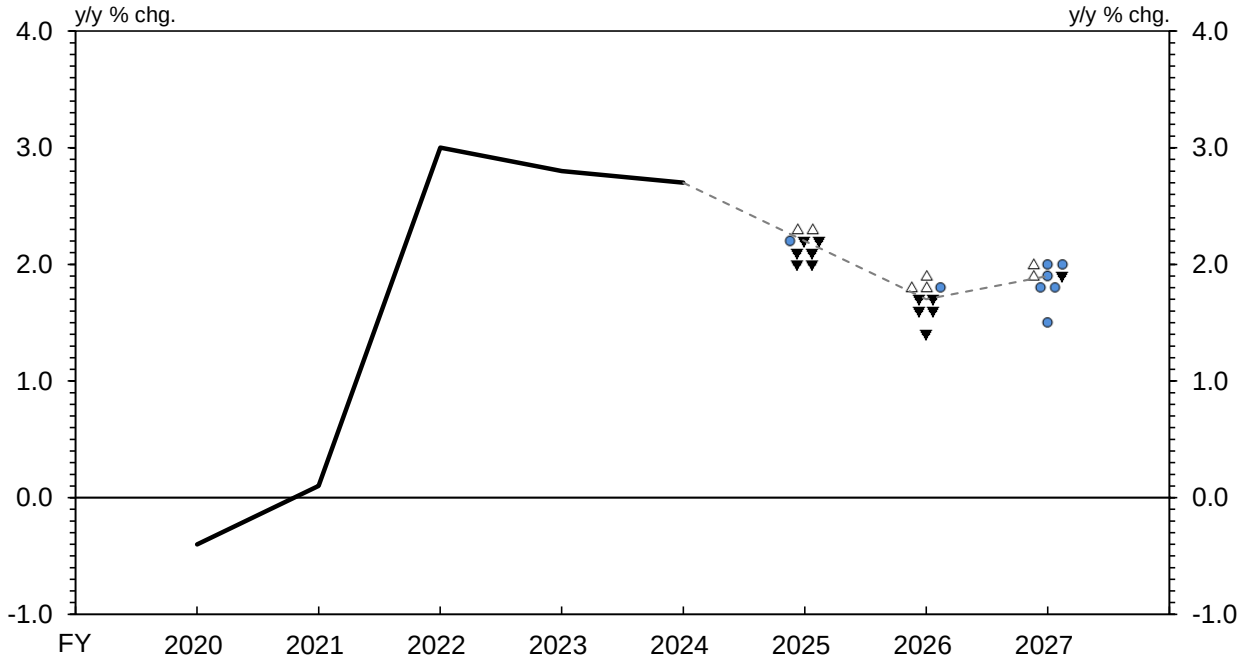
4. The CPI figures for fiscal 2024 are actual values.

Policy Board Members' Forecasts and Risk Assessments

(1) Real GDP



(2) CPI (All Items Less Fresh Food)



Notes: 1. The solid lines show actual figures, while the dotted lines show the medians of the Policy Board members' forecasts (point estimates).

2. The locations of ●, △, and ▼ in the charts indicate the figures for each Policy Board member's forecasts to which they attach the highest probability. The risk balance assessed by each Policy Board member is shown by the following shapes: ● indicates that a member assesses "upside and downside risks as being generally balanced," △ indicates that a member assesses "risks are skewed to the upside," and ▼ indicates that a member assesses "risks are skewed to the downside."

The Background[7]

I. Current Situation of Economic Activity and Its Outlook

A. Economic Developments

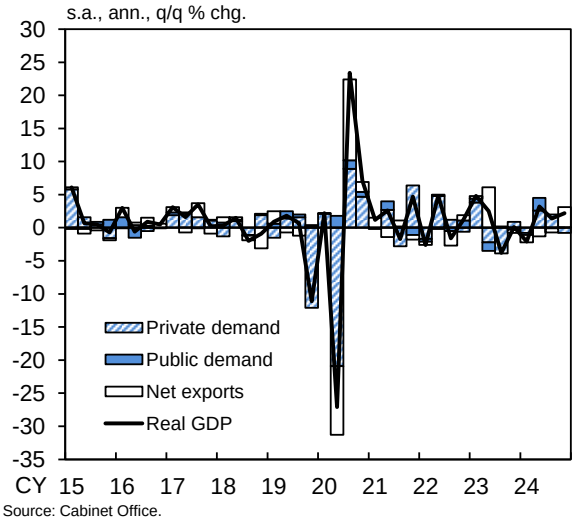
Japan's economy has recovered moderately, although some weakness has been seen in part.

Real GDP increased for three consecutive quarters, registering 0.6 percent growth on a quarter-on-quarter basis in the October-December quarter of 2024, and 2.2 percent on an annualized basis (Chart 1). Looking at the breakdown, although private consumption has been on a moderate increasing trend, on the back of an improvement in real disposable income, it was more or less flat in the October-December quarter, reflecting the reactionary decline following the rise in the previous quarter due to the effects of hot weather during the summer and stockpiling demand to prepare for natural disasters. Business fixed investment increased, mainly led by projects related to semiconductors. Net exports made a clearly positive contribution to real GDP growth, since exports increased, mainly led by services, while imports saw a relatively significant decrease. In this situation, the output gap -- which captures the utilization of labor and capital -- narrowed within negative territory and was at around 0 percent in the October-December quarter (Chart 2).

Chart 1: Real GDP

1. Level

2. Annualized Quarterly Growth Rate

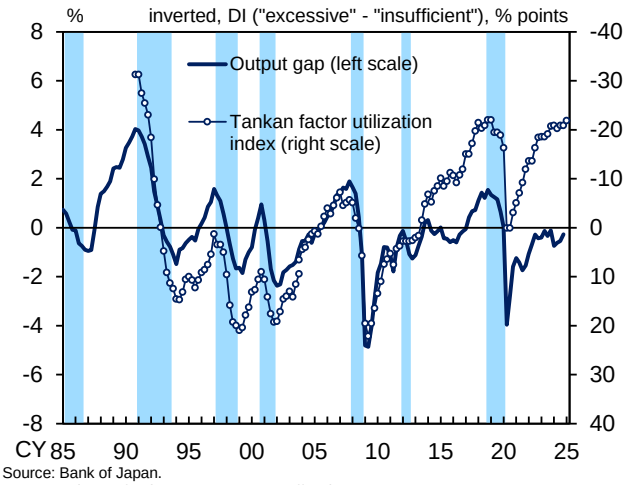


Source: Cabinet Office.

[7] "The Background" provides explanations of "The Bank's View" decided by the Policy Board at the Monetary Policy Meeting held on April 30 and May 1, 2025.

It can be judged from monthly indicators and high-frequency data since then that Japan's economy has recovered moderately, although weakness has been seen in consumer sentiment against the background of the rise in food prices. In the corporate sector, exports and production have continued to be more or less flat as a trend, although there has been some front-loading due to the increase in U.S. tariffs. Corporate profits have been on an improving trend, partly due to progress in the pass-through of cost increases to selling prices, and business sentiment has stayed at a favorable level. In this situation, business fixed investment has been on a moderate increasing trend. Business fixed investment plans in the March 2025 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) and various leading indicators suggest that firms have maintained their active business fixed investment stance so far. In the household sector, the upward momentum in employee income has become clear, reflecting a continued rise in the number of employed persons and a steady increase in bonuses. Private consumption has maintained its moderate increasing trend on the whole, supported by the improvement in real employee income, although the effects of consumers' increased thriftiness due to the rise in food prices have been seen in the consumption of nondurable goods. In this situation, the diffusion index (DI) for employment conditions for all industries and enterprises in the March *Tankan* shows that net "insufficient employment" expanded slightly from the previous survey in December; in particular, in nonmanufacturing, the sense of labor shortage has grown to the highest level since the early 1990s. As a result, the weighted average DI for production capacity and employment conditions

Chart 2: Output Gap



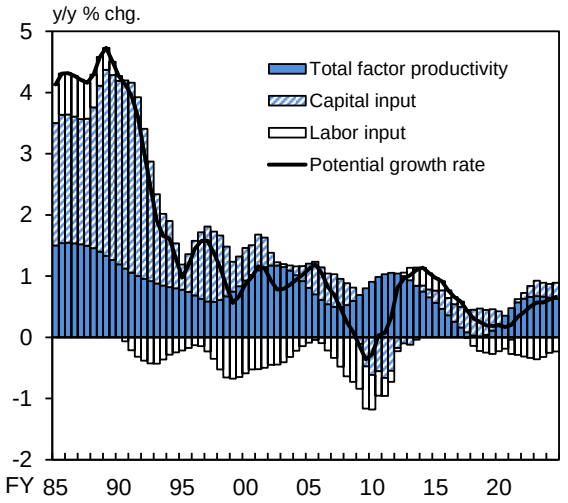
Source: Bank of Japan.
Notes: 1. Figures for the output gap are staff estimates.
2. The *Tankan* factor utilization index is calculated as the weighted average of the production capacity DI and the employment conditions DI for all industries and enterprises. The capital and labor shares are used as weights. There is a discontinuity in the data for December 2003 due to a change in the survey framework.
3. Shaded areas denote recession periods.

has continued to show a significantly large net "insufficient" (Chart 2).

Japan's economic growth is likely to moderate, as trade and other policies in each jurisdiction lead to a slowdown in overseas economies and to a decline in domestic corporate profits and other factors, although factors such as accommodative financial conditions are expected to provide support.[8] Thereafter, Japan's economic growth rate is likely to rise, with overseas economies returning to a moderate growth path. Comparing the projections with those presented in the previous Outlook Report, the projected real GDP growth rates for fiscal 2025 and 2026 are lower due to the effects of trade and other policies in each jurisdiction.

The recent potential growth rate is estimated to be around 0.5 percent: while the downtrend in working hours reflecting working-style reforms has continued to push down the rate, capital stock has increased moderately and total factor productivity (TFP) has continued to rise (Chart 3).[9] As for the outlook, the potential growth rate is expected to rise moderately. This is based on the projection that, although there will be less room for the number of employed persons to increase, (1) growth in TFP will accelerate, mainly on the back of advances in digitalization and the resulting improvement in the efficiency of resource allocation, as well as an expansion in

Chart 3: Potential Growth Rate



Source: Bank of Japan.
Note: Figures are staff estimates. Figures for the second half of fiscal 2024 are those for 2024/Q4.

[8] See Box 1 for the situation surrounding trade policies and its impact.

[9] However, the output gap and the potential growth rate, which are estimated based on specific assumptions regarding trends in production factors, should be interpreted with considerable latitude.

investment in human capital; (2) the decline in working hours will come to a halt, reflecting the diminishing effects of working-style reforms; and (3) capital stock will continue to increase.[10] These developments are likely to be encouraged by the government's various measures and by accommodative financial conditions.

Details of the outlook for each fiscal year are as follows. In fiscal 2025, Japan's economic growth is likely to moderate to around the same level as the potential growth rate, since it is projected that trade and other policies in each jurisdiction will lead to a slowdown in overseas economies and to heightened uncertainties, and that these factors will push down domestic and external demand. Downward pressure on goods exports stemming from the slowdown in overseas economies is likely to increase, while these exports are expected to see fluctuations reflecting the front-loading due to the increase in U.S. tariffs and a reactionary decline. On the other hand, inbound tourism demand, which is categorized under services exports, is highly likely to be solid, if foreign exchange rates remain at around current levels. Corporate profits are expected to turn to a downtrend, mainly in manufacturing, as the effects of the slowdown in overseas economies and of a deterioration in export profitability due to tariffs strengthen. In this situation, growth momentum in business fixed investment is highly likely to slow. This is because, although moves to clear the high levels of order backlogs and labor-saving investment to address labor shortages, mainly in nonmanufacturing, are expected to provide some support, a deterioration in the profit environment and the heightened

[10] See Box 2 for productivity trends in Japan.

uncertainties are likely to push down business fixed investment. Private consumption is projected to maintain its moderate increasing trend, as wage increases continue as a result of the annual spring labor-management wage negotiations, although it is expected to continue to be affected by a deterioration in consumer sentiment stemming from the rise in food prices for the time being.

In fiscal 2026, Japan's economic growth is likely to accelerate moderately. With a pick-up in overseas economies, goods exports are expected to head toward a recovery. With corporate profits turning to an increase, growth in business fixed investment is likely to gradually increase momentum, pushed up by a decline in the uncertainties. The growth rate in nominal wages is projected to decelerate, lagging somewhat behind the deterioration in corporate profits. That said, with a continued uptrend in employee income, private consumption is highly likely to be resilient.

In fiscal 2027, Japan's economy is likely to accelerate at a pace above its potential growth rate. With overseas economies recovering further, the uptrend in goods exports is expected to become clear. With a continued improvement in corporate profits, business fixed investment is likely to increase firmly, pushed up by labor-saving investment to address labor shortages, investment for capacity expansion, investment projects to adapt to changes in the trade structure and supply chains, among other investments. Private consumption is expected to return to a moderate increasing trend, as the

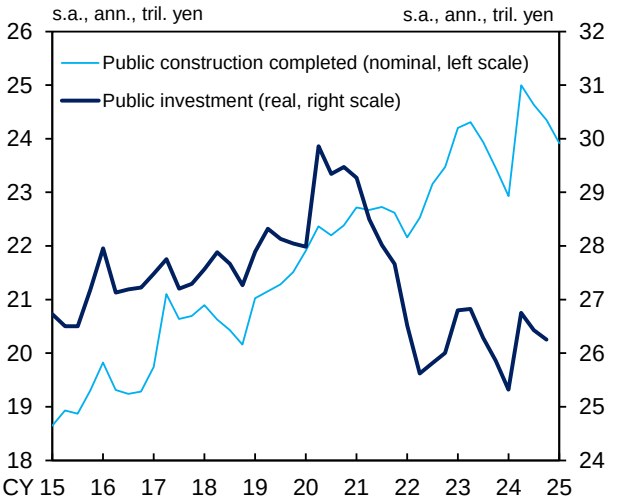
growth rate in nominal wages accelerates again reflecting the increase in corporate profits.

B. Developments in Major Expenditure Items and Their Background

Government Spending

Public investment has been more or less flat (Chart 4). While construction based on the government's economic measures, including construction related to building national resilience, has progressed, the amount of public construction completed -- a coincident indicator of public investment -- has been more or less flat at a high level in nominal terms.

Chart 4: Public Investment



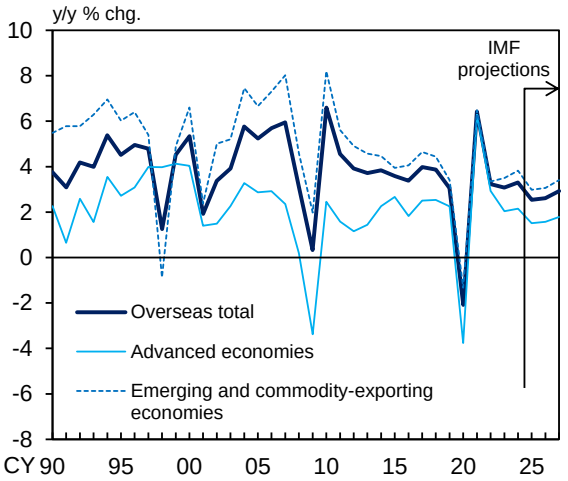
Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Note: The figure for 2025/Q1 is the January-February average.

Considering the developments in various leading indicators, public investment is likely to be more or less flat.[11] Government consumption is projected to continue increasing moderately, reflecting an uptrend in healthcare and nursing care expenditures.

Overseas Economies

Overseas economies have grown moderately on the whole, although some weakness has been seen in part, reflecting trade and other policies in each jurisdiction (Chart 5). By region, the U.S. economy has grown moderately, although some weakness has been seen in part. European economies have been relatively weak, mainly in manufacturing. As for the Chinese economy, despite government support, the pace of

Chart 5: Overseas Economies



Sources: IMF; Ministry of Finance.
Note: Figures are the weighted averages of real GDP growth rates using countries' share in Japan's exports as weights. The real GDP growth rates are compiled by the IMF, and the rates from 2025 onward are its projections in the April 2025 *World Economic Outlook* (WEO). Figures for advanced economies are those for the United States, the euro area, and the United Kingdom. Figures for emerging and commodity-exporting economies are those for the rest of the world.

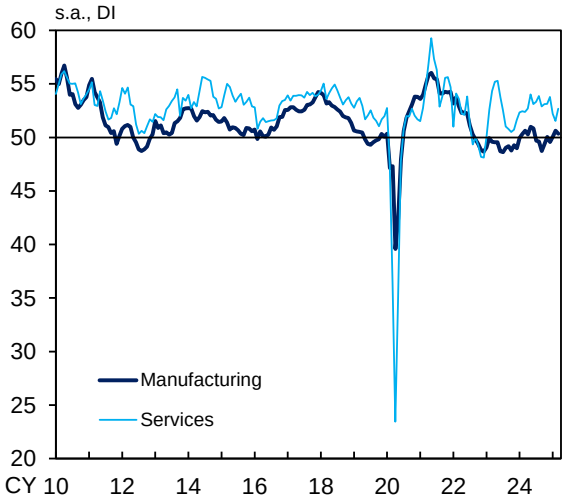
[11] The five-year acceleration measures for building national resilience with a project size of about 15 trillion yen were decided by the Cabinet in December 2020. In these measures, public investment projects for disaster prevention, disaster mitigation, and building national resilience are to be implemented intensively over five years from fiscal 2021 through fiscal 2025. The government's economic measures decided by the Cabinet in November 2024 also include efforts to implement the acceleration measures.

improvement in the economy has been on a slowing trend, with continued downward pressure from adjustments in the real estate and labor markets. Emerging and commodity-exporting economies other than China have improved moderately on the whole. Among those in Asia, which have close links to Japan's economy, the NIEs and ASEAN economies have improved moderately as global demand for IT-related goods has recovered, mainly led by AI-related goods.

Looking at the Global PMI to see the current situation for the global economy, figures for the services industry have been clearly above 50 -- the break-even point between improvement and deterioration in business conditions -- while figures for the manufacturing industry have been at around 50 (Chart 6).

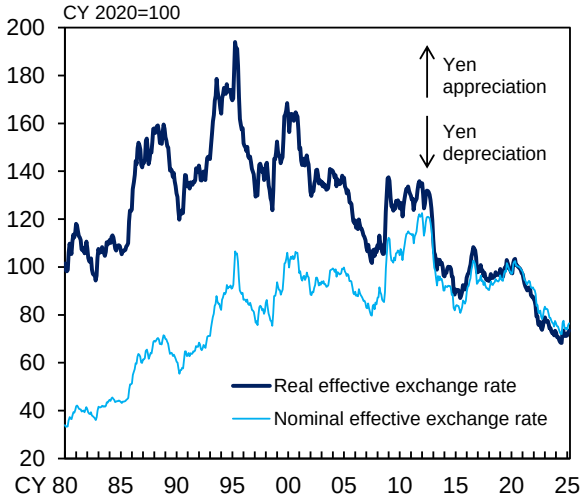
As for the outlook, although trade and other policies in each jurisdiction are expected to lead to a slowdown in overseas economies for a while, they are projected to see a gradual acceleration in their growth rate thereafter, and then grow moderately. The trade policy in each jurisdiction is likely to push down overseas economies for a while through affecting (1) global trade activity and (2) business and household sentiment around the world and global financial and capital markets. Looking at such developments by region, the U.S. economy is likely to decelerate for a while since it is expected that the trade policy in each jurisdiction will lead to pushing down trade activity, raising prices, and increasing uncertainties; thereafter, however, the economy is expected to grow moderately. Other major economies are likely to decelerate for a while

Chart 6: Global PMI



Source: Copyright © 2025 by S&P Global Market Intelligence, a division of S&P Global Inc. All rights reserved.
Note: Figures for manufacturing are the J.P.Morgan Global Manufacturing PMI. Figures for services are the J.P.Morgan Global Services Business Activity Index.

Chart 7: Effective Exchange Rates



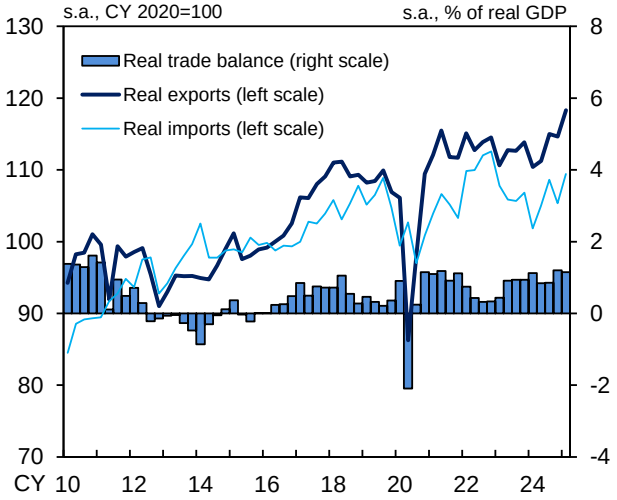
Source: BIS.
Note: Figures are based on the broad effective exchange rate indices. Figures prior to 1994 are calculated using the narrow indices.

because it is projected that trade and other policies in each jurisdiction will lead to pushing down trade activity and increase uncertainties; thereafter, however, these economies are likely to grow moderately.

Exports and Imports

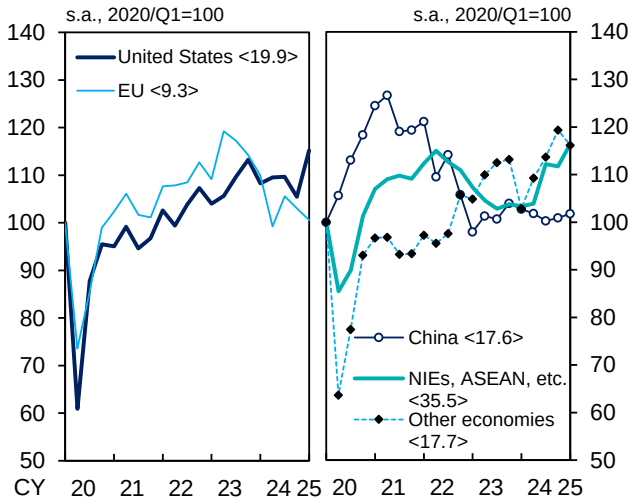
Exports have continued to be more or less flat as a trend, although there has been some front-loading due to the increase in U.S. tariffs (Chart 8). By region, exports to the United States have increased markedly, as the impact of the U.S. port strike has dissipated, and due to an increase in exports of goods such as certain automobile parts, likely reflecting the front-loading of exports due to the increase in tariffs (Chart 9). Exports to Europe, especially of capital goods, have continued to be relatively weak, reflecting subdued business fixed investment in the region. Exports to China have remained more or less flat at low levels due to the slowdown in the Chinese economy and the leveling-off of demand for semiconductor production equipment. Growth in exports to the NIEs, ASEAN, and some other Asian economies has increased momentum, reflecting solid global demand for AI-related goods and front-loading of exports of IT-related goods due to the increase in U.S. tariffs, although exports of some components for smartphones have been relatively weak. Exports to other economies have been on an increasing trend, mainly led by automobiles, albeit with fluctuations, and front-loading of exports of automobile parts to economies such as Canada and Mexico has been seen recently. By goods, exports of automobile-related goods have increased recently, reflecting moves toward restocking of inventories in the United States and front-loading of exports

Chart 8: Real Exports and Imports



Sources: Bank of Japan; Ministry of Finance; Cabinet Office.
Note: Based on staff calculations.

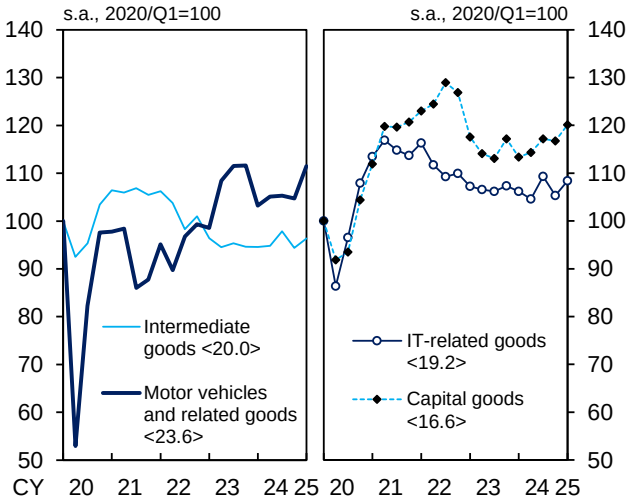
Chart 9: Real Exports by Region



Sources: Bank of Japan; Ministry of Finance.
Notes: 1. Based on staff calculations. Figures in angular brackets show the share of each country or region in Japan's total exports in 2024.
2. Figures for the EU exclude those for the United Kingdom for the entire period.

of goods, such as certain automobile parts, due to the increase in tariffs (Chart 10). Exports of capital goods have picked up, with external demand for construction machinery and other items seeing a halt in decline and exports of semiconductor production equipment following an uptrend. Exports of IT-related goods have been more or less flat on the whole: while exports of some components for smartphones have been relatively weak, exports of IT-related goods have been supported by an increase in demand for AI-related goods such as data servers. Exports of IT-related goods to the NIEs, ASEAN, and some other Asian economies have recently increased, likely induced by the front-loading of production due to the increase in U.S. tariffs. Meanwhile, exports of intermediate goods have been at low levels, due to continued oversupply in Asia.

Chart 10: Real Exports by Type of Goods



Sources: Bank of Japan; Ministry of Finance.
Note: Based on staff calculations. Figures in angular brackets show the share of each type of goods in Japan's total exports in 2024.

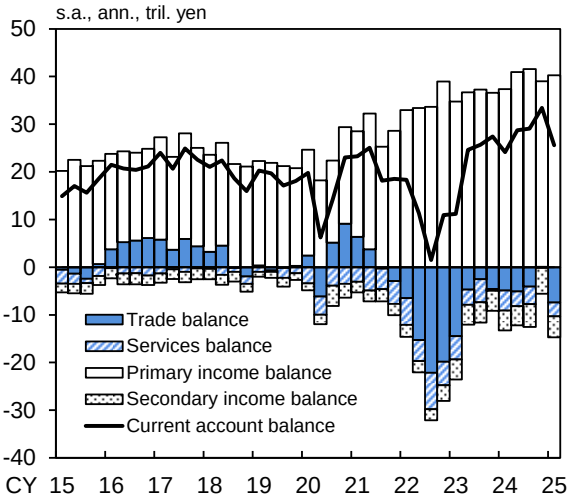
As for the outlook, exports are likely to be generally under increasing downward pressure stemming from the slowdown in overseas economies, while, for the time being, front-loading of exports due to the increase in U.S. tariffs and a reactionary decline are likely to be seen. Thereafter, with an acceleration in the growth rate of overseas economies, exports are projected to return to an uptrend.

Imports have been more or less flat (Chart 8). They are expected to follow a moderate uptrend on the back of developments in domestic demand.

External Balance

The nominal current account surplus has remained at a high level (Chart 11). The trade balance has remained on a slight deficit trend, albeit with fluctuations. Despite a surplus in the travel balance -- which reflects the increase in inbound tourism demand (Chart 12) -- the services balance has remained on a slight deficit trend on the whole, as payments for digital-related services have been at high levels. Meanwhile, the primary income balance surplus has remained at a high level, supported by factors such as receipts of direct investment income converted into yen.

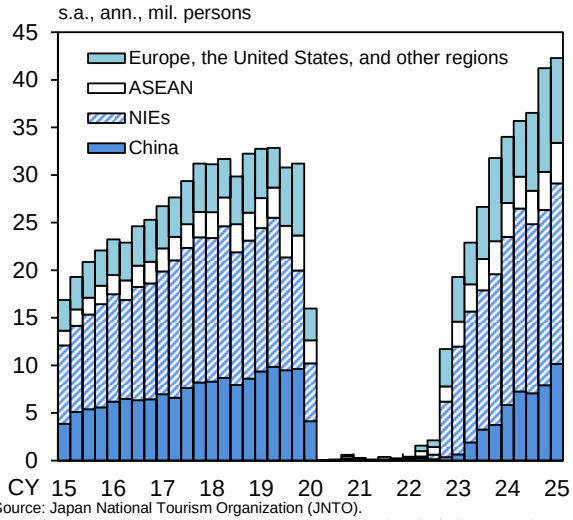
Chart 11: Current Account



Source: Ministry of Finance and Bank of Japan.
Note: Figures for 2025/Q1 are January-February averages.

The nominal current account balance is highly likely to follow a declining trend for the time being. This is based on the projection that (1) the trade balance will remain on a deficit trend against the background of the decline in goods exports due to the slowdown in overseas economies and (2) downward pressure will be exerted on the primary income balance, reflecting a deterioration in the profits of overseas subsidiaries. Thereafter, the nominal current account surplus is likely to increase moderately as overseas economies recover.

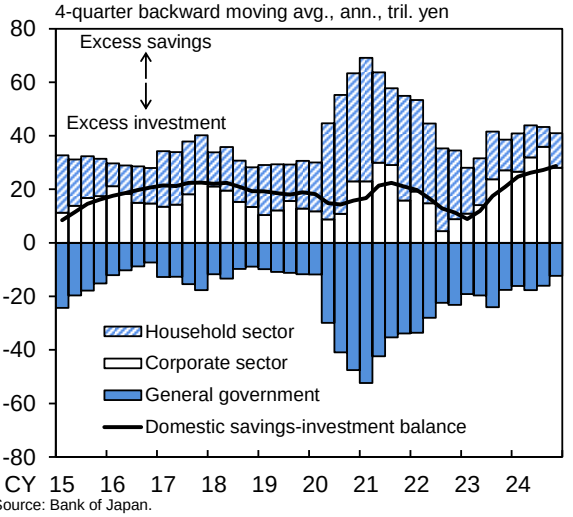
Chart 12: Number of Inbound Visitors



Source: Japan National Tourism Organization (JNTO).
Note: Figures for Europe, the United States, and other regions include seasonal adjustment errors.

In terms of the savings-investment balance, overall excess savings in Japan have continued on a moderate expanding trend, mainly due to an increase in corporate profits. However, overall excess savings in the economy are projected to turn to a decline, as corporate profits deteriorate due to the slowdown in overseas economies (Chart 13). Thereafter, overall excess savings are projected to expand moderately, because the fiscal balance is likely to improve at a pace that

Chart 13: Savings-Investment Balance



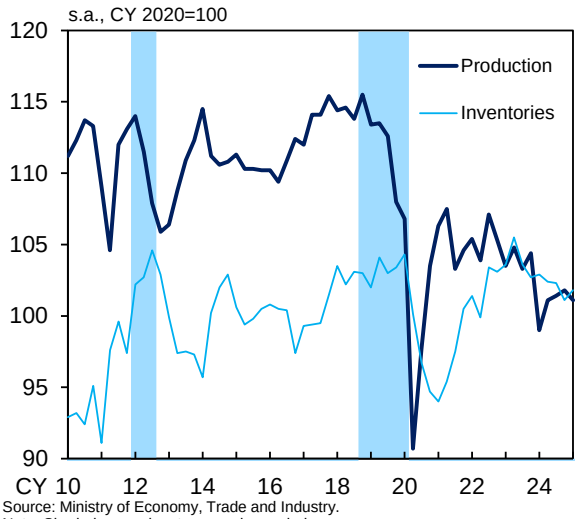
Source: Bank of Japan.

somewhat exceeds the pace of decline in excess savings in the private sector.

Industrial Production

Industrial production has continued to be more or less flat (Chart 14). By major industry, production of "transport equipment" has increased recently due to a rise in automobile production to address the increased order backlogs and the front-loading of production of some automobile parts due to the rise in U.S. tariffs. Production of "electronic parts and devices" has been more or less flat. This is because the weakness in production of some components for smartphones and the increase in demand for AI-related goods such as data servers have generally offset each other. While production of "general-purpose, production, and business-oriented machinery" had continued on a declining trend for a long time, it has recently been more or less flat, as external demand for construction machinery and other items has stopped declining and solid production of semiconductor production equipment has provided support. Meanwhile, production of "chemicals (excluding medicine)" has continued on a moderate declining trend, mainly due to an oversupply, particularly in Asia.

Chart 14: Industrial Production



Source: Ministry of Economy, Trade and Industry.
Note: Shaded areas denote recession periods.

While industrial production is projected to see an increase reflecting a front-loading of production due to the rise in U.S. tariffs and the reactionary decline for the time being, it is likely remain generally under increasing downward pressure stemming from the slowdown in overseas economies. Thereafter, with an acceleration in the growth rate of overseas economies, industrial production is likely to return to an uptrend.

Corporate Profits

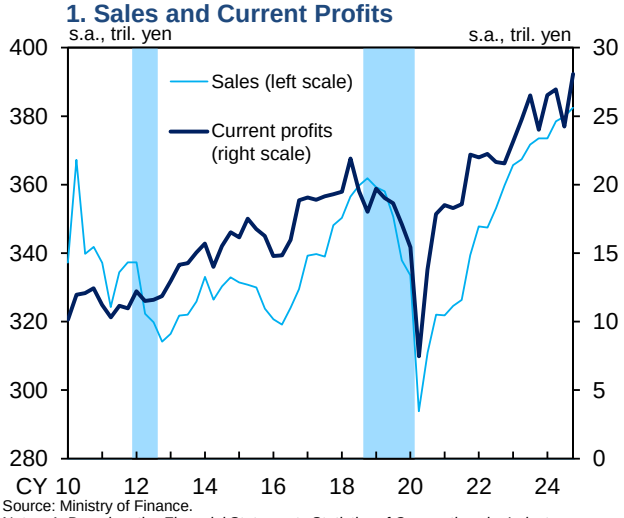
Corporate profits have been on an improving trend. According to the *Financial Statements Statistics of Corporations by Industry, Quarterly*, current profits for all industries and enterprises in the October-December quarter of 2024 saw a relatively large increase from the previous quarter, reaching the highest level since the April-June quarter of 1985, from when comparable data are available (Chart 15). This increase mainly reflects the rise in non-operating profits due to the depreciation of the yen. Operating profits for all industries and enterprises also increased. This is mainly due to solid demand for AI-related goods (electrical machinery, and information and communication electronics equipment), the increase in orders related to business fixed investment (general-purpose, production, and business-oriented machinery), and progress in the pass-through of cost increases to selling prices (construction).

By industry and firm size, current profits of manufacturers, regardless of firm size, have increased, reflecting the yen's depreciation. As for nonmanufacturers, while current profits of large firms have been more or less flat, those of small and medium-sized firms have increased, mainly led by the services industry, against the background of factors such as solid inbound tourism demand and an increase in domestic travel demand.

Business sentiment has stayed at a favorable level. Looking at the March *Tankan*, the business conditions DI for all industries and enterprises has remained clearly positive (net "favorable") and

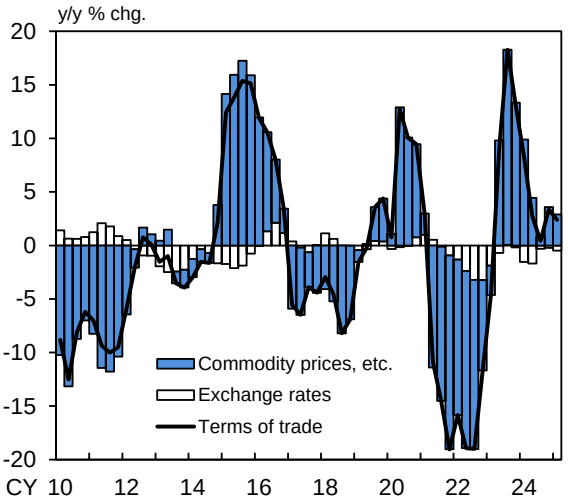
Chart 15: Indicators Related to Corporate Profits

1. Sales and Current Profits



Source: Ministry of Finance.
Notes: 1. Based on the *Financial Statements Statistics of Corporations by Industry, Quarterly*. Excluding "finance and insurance" and "pure holding companies."
2. Shaded areas denote recession periods.

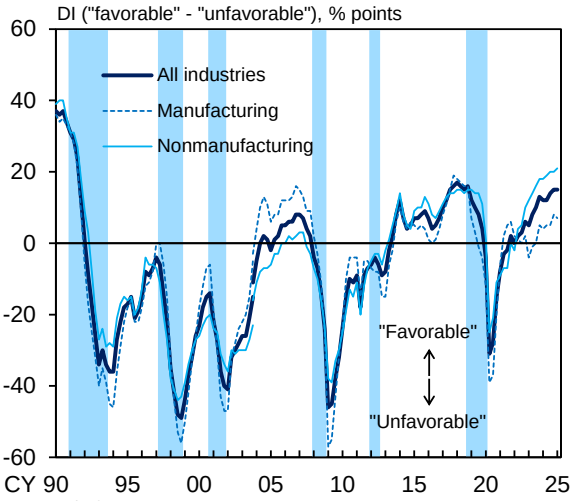
2. Contribution to Changes in Terms of Trade



Source: Bank of Japan.
Notes: 1. The contribution of changes in commodity prices, etc. is calculated using changes in export/import price indexes on a contract currency basis. The contribution of changes in exchange rates is calculated using the difference between export/import price indexes on a yen basis and those on a contract currency basis.
2. Terms of trade = Export price index on a yen basis / Import price index on a yen basis

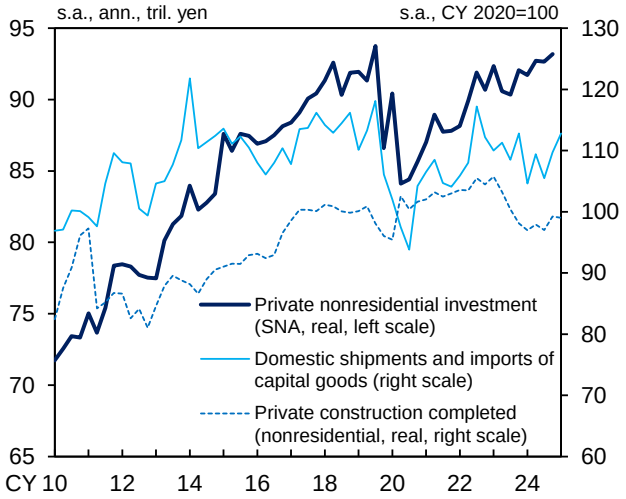
unchanged from the previous survey in December at a value of 15 (Chart 16). By industry, the DI for manufacturing has been more or less unchanged on the whole from the previous survey. This reflects the fact that, although the DI for basic materials has deteriorated -- mainly led by large firms in industries such as "chemicals" and "iron and steel" -- due to weak external demand, the DI for the processing industry has improved slightly on the back of a recovery in automobile production. That said, the effects of U.S. trade policy have likely not yet been fully reflected in the survey results, since most of the survey forms were collected before mid-March. With resilient inbound tourism demand and domestic services demand, the DI for nonmanufacturing has remained at a high level, as progress in the pass-through of cost increases to selling prices has been widely observed.

Chart 16: Business Conditions



Source: Bank of Japan.
Notes: 1. Based on the *Tankan*. All enterprises. There is a discontinuity in the data for December 2003 due to a change in the survey framework.
2. Shaded areas denote recession periods.

Chart 17: Coincident Indicators of Business Fixed Investment



Sources: Cabinet Office; Ministry of Economy, Trade and Industry; Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. The figure for private construction completed for 2025/Q1 is the January-February average.
2. Figures for real private construction completed are based on staff calculations using the construction cost deflators.

Regarding the outlook, corporate profits are likely to turn to a declining trend, mainly for manufacturing, as the effects of the slowdown in overseas economies and of a deterioration in export profitability due to tariffs strengthen. Thereafter, corporate profits are expected to return to an improving trend due to an increase in domestic and external demand.

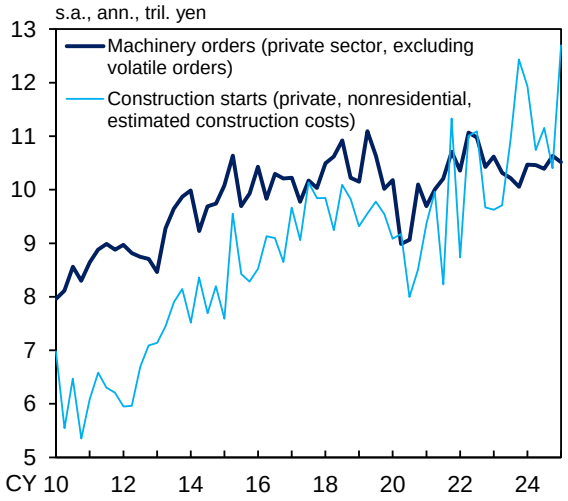
Business Fixed Investment

Business fixed investment has been on a moderate increasing trend (Chart 17). The aggregate supply of capital goods -- a coincident indicator of machinery investment -- has increased recently, as demand for AI-related investment has been solid and large-scale projects related to semiconductors have pushed

up the aggregate supply. Private construction completed (nonresidential) -- a coincident indicator of construction investment -- has been more or less flat recently. This reflects the fact that, although construction demand related to logistics facilities, factories, and urban redevelopment has been resilient, delays in construction projects due to high construction material prices and labor shortages have pushed down construction volumes.

Machinery orders -- a leading indicator of machinery investment -- have been at relatively high levels (Chart 18). Developments in machinery orders by industry are as follows. In manufacturing, orders have been at relatively high levels, supported by solid AI-related demand and resilient demand for investment in growth areas, such as components for semiconductors and electric vehicles. Orders from the nonmanufacturing industry have been solid, mainly led by digital- and labor saving-related investments. Construction starts (in terms of planned expenses for private and nonresidential construction) -- a leading indicator of construction investment -- have been at high levels, albeit with fluctuations stemming from large-scale projects, as construction of logistics facilities and factories, as well as construction related to urban redevelopment have progressed. Looking at business fixed investment plans (in nominal terms) in the March *Tankan*, business fixed investment (on the basis close to GDP definition; business fixed investment -- including software and R&D investments but excluding land purchasing expenses -- for all industries and enterprises including financial institutions) for fiscal 2024 shows a firm increase, registering a

Chart 18: Leading Indicators of Business Fixed Investment

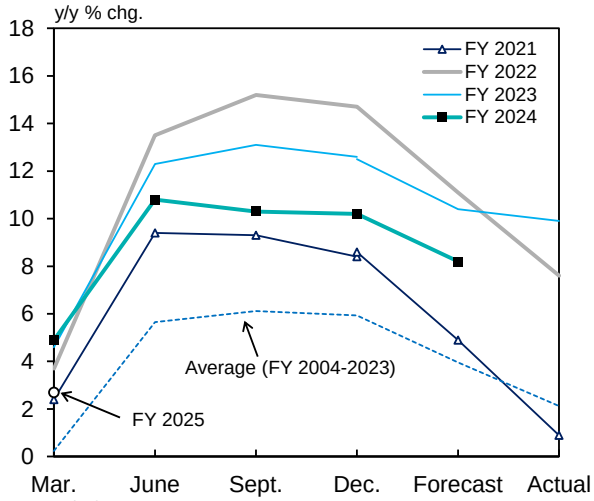


Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. Volatile orders are orders for ships and orders from electric power companies.
2. The figure for machinery orders for 2025/Q1 is the January-February average.

year-on-year rate of increase of 8.2 percent (Chart 19). While the reported rate of business fixed investment plans for fiscal 2025 also indicates an increase of 2.7 percent, this could be revised considerably depending on the future course of the trade policy in each jurisdiction.

Growth momentum in business fixed investment is highly likely to slow, as the deterioration in the profit environment and the heightened uncertainties are likely to push down the investment, although moves to clear the high levels of order backlogs are expected to provide some support. Thereafter, with an upturn in corporate profits, growth in business fixed investment is likely to gradually increase momentum because it is expected that a decline in the uncertainties will push up business fixed investment and that investment for capacity expansion and for restructuring supply chains will become active. Medium- to long-term investment that is expected to support business fixed investment during the projection period includes (1) labor-saving and efficiency-improving investment to address structural labor shortages and IT-related investment to digitalize business activities; (2) construction investment in logistics facilities, resulting from expanding e-commerce, and in offices and commercial facilities related to urban redevelopment; (3) investment in growth areas and to address environmental issues, such as decarbonization; and (4) semiconductor-related investment that is mainly aimed at strengthening supply chains and that also reflects government support. Regarding investment related to growth areas, such as digitalization and semiconductors, capital accumulation in these areas tends to take time

Chart 19: Developments in Business Fixed Investment Plans



Source: Bank of Japan.
Notes: 1. Based on the *Tankan*. All industries including financial institutions.
2. Including software and R&D investments and excluding land purchasing expenses. R&D investment is not included before the March 2017 survey.
3. There are discontinuities in the data for December 2021 and December 2023 due to changes in the survey sample.

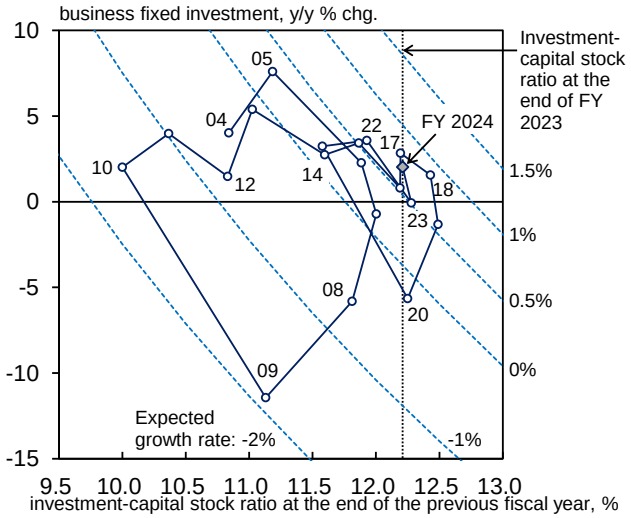
and adjustment pressure is less likely to be exerted due to high economic depreciation rates in reflection of the developments in technologies (Chart 20).

Employment and Income Situation

The employment and income situation has improved moderately.

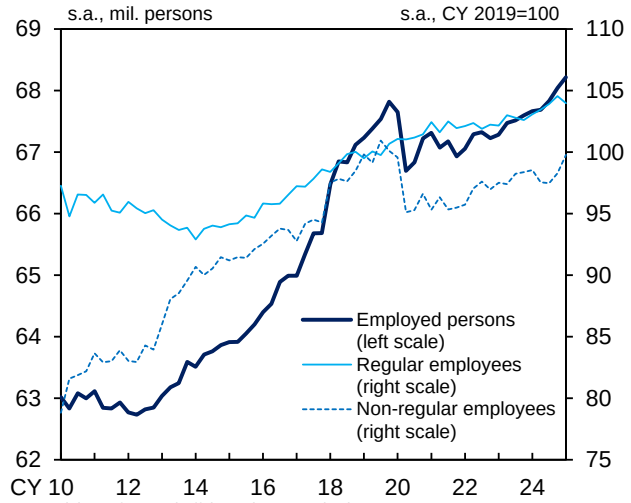
The number of employed persons has continued to increase steadily (Chart 21). The number of regular employees has been on a moderate uptrend, mainly in the information and communications industry and in the medical, healthcare, and welfare services industry, both of which have faced severe labor shortages. While the number of non-regular employees in industries such as the face-to-face services industry has been on an increasing trend, the number of non-regular employees overall has remained more or less flat at below pre-pandemic levels, as firms have made a shift to regular employment amid a strong sense of labor shortage. With regard to labor market conditions, the unemployment rate has remained at a low level (Chart 22). The job vacancy rate in the *Survey on Labour Economy Trend* and the number of job postings including those advertised through private job-search services (the Job Postings Index for full-time jobs) show that labor market conditions for full-time employees have remained tight (Chart 23).[12] Meanwhile, the labor

Chart 20: Capital Stock Cycles



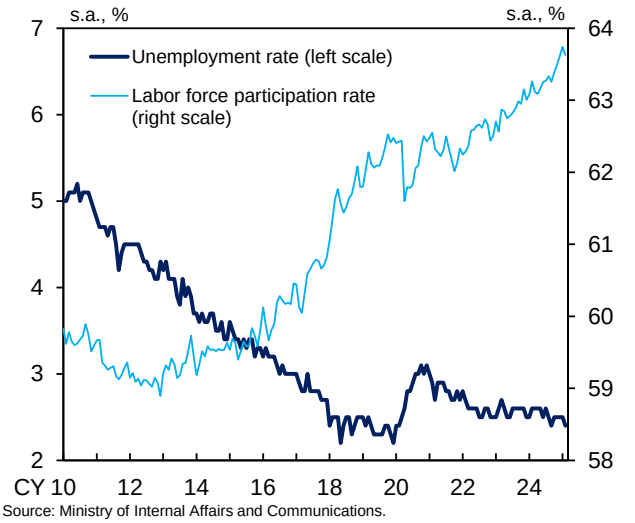
Source: Cabinet Office.
Note: Each broken line represents the combination of the rate of change in business fixed investment and the investment-capital stock ratio at a certain expected growth rate. The figure for fiscal 2024 is the 2024/Q2-Q4 average.

Chart 21: Number of Employed Persons



Source: Ministry of Internal Affairs and Communications.
Note: Figures for regular employees and non-regular employees prior to 2013 are based on the "detailed tabulation" in the *Labour Force Survey*. Figures for 2025/Q1 are January-February averages.

Chart 22: Unemployment Rate and Labor Force Participation Rate



Source: Ministry of Internal Affairs and Communications.

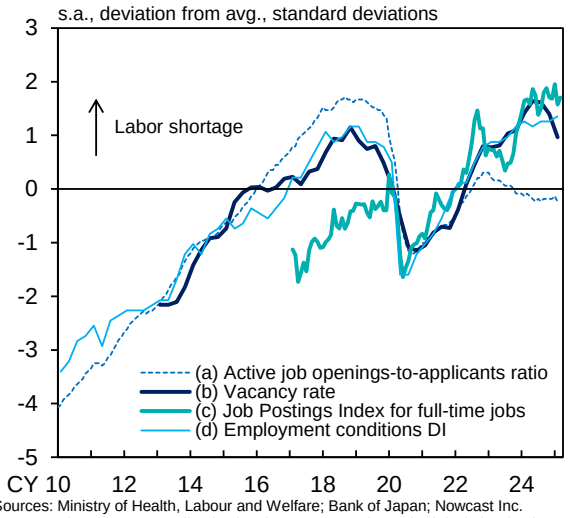
[12] The job vacancy rate in the *Survey on Labour Economy Trend* is calculated as the number of unfilled vacancies divided by the number of full-time employees. The Job Postings Index for full-time jobs is based on the total number of full-time jobs advertised through private online job boards and the Public Employment Service Center (adjusted for duplicate postings).

force participation rate has remained on a moderate uptrend, particularly for women (Chart 22). In contrast, the active job openings-to-applicants ratio has been at a low level, indicating somewhat less tight labor conditions than the aforementioned indicators.[13]

With regard to the outlook for the employment situation, the number of employed persons is expected to continue increasing moderately, mainly for regular employees in industries with labor shortages. However, with labor force participation of women and seniors having advanced to a high degree thus far, the pace of increase is highly likely to decelerate, because it has become more difficult for labor supply to increase reflecting demographic developments. Under these circumstances, the unemployment rate is expected to follow a moderate declining trend, and is likely to be flat at a low level toward the end of the projection period, as the pace of increase in labor demand reflecting economic growth and that in labor force participation are expected to be more or less the same.[14]

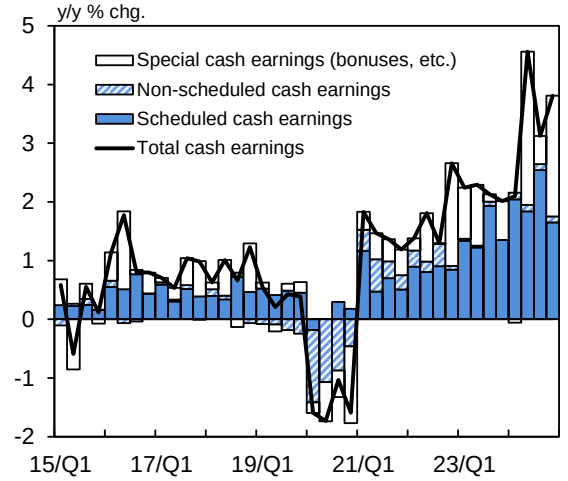
On the wage side, nominal wages per employee have increased clearly (Chart 24).[15] Looking at the breakdown, the year-on-year rate of increase

Chart 23: Various Measures of Labor Market Conditions



Sources: Ministry of Health, Labour and Welfare; Bank of Japan; Nowcast Inc.
Notes: 1. Figures are normalized using the average and standard deviation for the period from 2013 onward (figures for the Job Postings Index for full-time jobs are normalized using the average and standard deviation for the period from 2017 onward). Figures for the vacancy rate are 2-quarter backward moving averages (figures from 2013 to 2014 are staff estimates). Figures for the employment conditions DI are for all industries and enterprises.
2. The data sources for (a), (b), (c), and (d) are the *Employment Referral Statistics*, the *Survey on Labour Economy Trend*, *HRog Wage Now*, and the *Tankan*, respectively.

Chart 24: Nominal Wages



Source: Ministry of Health, Labour and Welfare.
Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.
2. Figures from 2016/Q1 onward are based on continuing observations following the sample revisions.

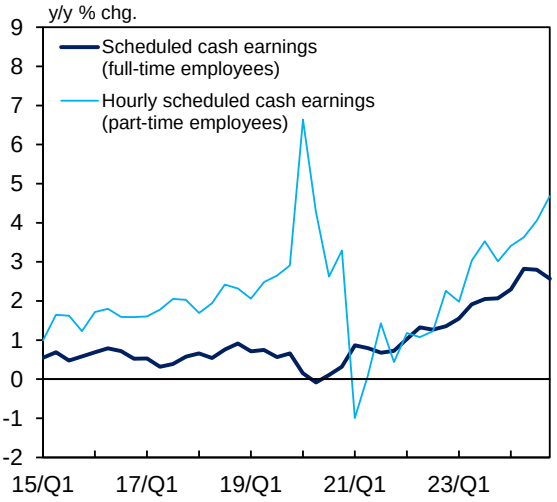
[13] The fact that developments in the active job openings-to-applicants ratio in the *Employment Referral Statistics* recently have differed from other measures of labor market conditions may be due to a decrease in the use of the Public Employment Security Office and an increase in the use of private employment agencies, resulting in the number of active job openings being relatively weak.

[14] See Box 3 for labor market conditions and labor mobility across firms.

[15] Wages in the *Monthly Labour Survey* are assessed on the basis of continuing observations, which are less susceptible to fluctuations due to sample revisions.

in scheduled cash earnings has remained at a relatively high level (Chart 25). Specifically, the rate of increase for full-time employees has been around 3 percent as a trend, when fluctuations -- such as those deriving from the number of working days -- are smoothed out. The year-on-year rate of increase in hourly scheduled cash earnings for part-time employees has remained on an uptrend, albeit with fluctuations, recently reaching a high growth rate of around 5 percent, as labor market conditions have remained tight. The year-on-year rate of increase in the average hourly wage for temporary and part-time jobs at the time of recruitment has also accelerated, albeit with fluctuations, and has been at around 5.5 percent recently. The year-on-year rate of change in non-scheduled cash earnings has been positive, mainly led by an increase in hourly wages for overtime work. Special cash earnings (bonuses) have increased firmly, mainly reflecting winter bonuses, as corporate profits have remained on an improving trend, and the share of small and medium-sized firms that have paid bonuses has risen.

Chart 25: Scheduled Cash Earnings



Source: Ministry of Health, Labour and Welfare.
Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.
2. Figures from 2016/Q1 onward are based on continuing observations following the sample revisions.

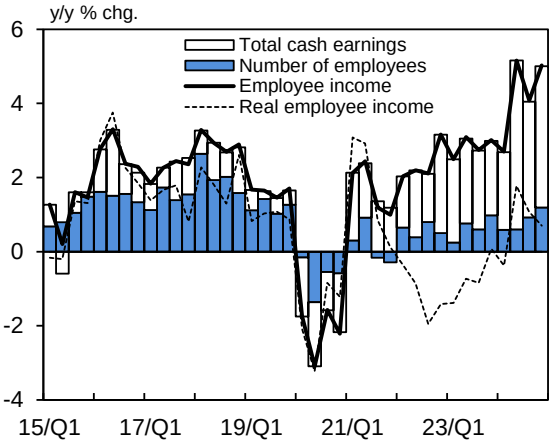
With regard to the outlook for wages, the wage growth rate (the rate of base pay increases) to be agreed in this year's annual spring labor-management wage negotiations is likely to somewhat exceed the high wage growth rate achieved last year.[16] In reflection of this, the rate of increase in scheduled cash earnings is highly likely to continue to show relatively high growth for the time being. On the other hand, non-scheduled cash earnings and special cash earnings (bonuses) are expected to be under

[16] See Box 4 for recent developments in wage increases and price-setting behavior.

greater downward pressure, mainly in the manufacturing industry, reflecting the growing impact of the slowdown in overseas economies. In light of these factors, nominal wages per employee are highly likely to continue increasing at their current pace for the time being, but then see a deceleration in their growth rate. In the middle of the projection period, base pay increases and scheduled cash earnings are projected to be under downward pressure, as they are expected to be affected, with some time lag, by the deterioration in corporate profits stemming from the slowdown in overseas economies. However, toward the end of the projection period, the rate of increase in nominal wages per employee is likely to accelerate again, as corporate profits improve on the back of a recovery in domestic and external demand. On this point, the feature of Japan's labor market is that the results of wage agreements reached by large manufacturing firms tend to have a significant impact on forming the so-called prevailing wage; given this, there are high uncertainties over the extent to which a decline in corporate profits of large manufacturing firms -- stemming from the slowdown in overseas economies -- will have a negative impact on the momentum in wage hikes, which has been strengthening due to a strong sense of labor shortage.

In light of the aforementioned employment and wage conditions, employee income has increased clearly in nominal terms (Chart 26). In real terms, the year-on-year rate of change in employee income has been positive recently. With regard to the outlook, nominal employee income is likely to continue to see a clear increase for the time being,

Chart 26: Employee Income



Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.
Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.
2. Employee income = Total cash earnings (*Monthly Labour Survey*) × Number of employees (*Labour Force Survey*)
3. Figures from 2016/Q1 onward are based on continuing observations following the sample revisions of the *Monthly Labour Survey*.
4. Figures for real employee income are based on staff calculations using the CPI (less imputed rent).

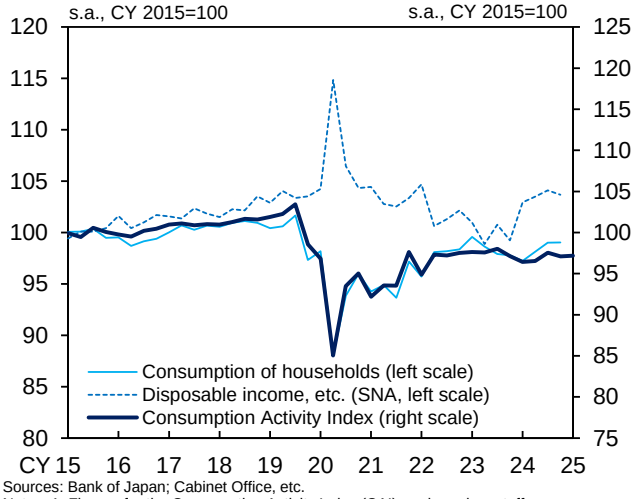
supported by the rise in nominal wages reflecting this year's annual spring labor-management wage negotiations. However, as the downward pressure on special cash earnings (bonuses) is likely to strengthen due to a deterioration in corporate profits, the pace of increase in nominal employee income is projected to decelerate. Toward the end of the projection period, the growth momentum in nominal employee income is likely to increase, as the nominal wage growth rate accelerates again in reflection of the recovery in corporate profits.

Household Spending

Private consumption has maintained its moderate increasing trend against the background of the improvement in the employment and income situation, despite weakness in consumer sentiment due to the impact of price rises and other factors.

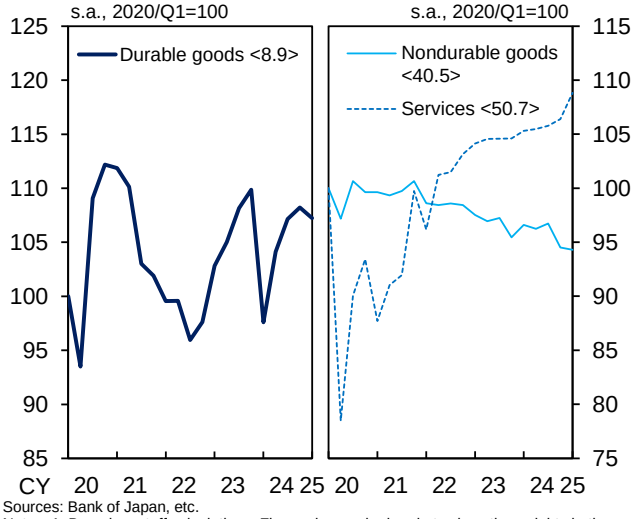
The Consumption Activity Index (CAI; real, travel balance-adjusted) -- which is calculated by combining various sales and supply-side statistics -- decreased in the October-December quarter of 2024, mainly for nondurable goods, because of a reactionary decline following the rise in sales of goods due to the effects of hot weather during the summer and stockpiling demand to prepare for natural disasters (Charts 27 and 28).[17] The index then turned to a slight increase on average in the January-February period of 2025, supported by an increase in services consumption. Looking at subsequent developments in private consumption from various sources, such as high-frequency

Chart 27: Real Private Consumption



Sources: Bank of Japan; Cabinet Office, etc.
Notes: 1. Figures for the Consumption Activity Index (CAI) are based on staff calculations. The CAI figures are travel balance adjusted; i.e., they exclude inbound tourism consumption and include outbound tourism consumption. The figure for 2025/Q1 is the January-February average.
2. Figures for consumption of households exclude imputed rent.
3. "Disposable income, etc." consists of disposable income and adjustment for the change in pension entitlements, and real values are obtained using the deflator of consumption of households.

Chart 28: Consumption Activity Index (CAI, Real)

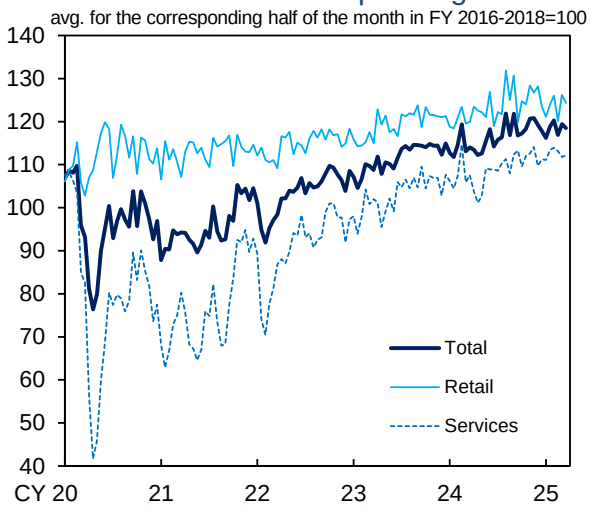


Sources: Bank of Japan, etc.
Notes: 1. Based on staff calculations. Figures in angular brackets show the weights in the CAI. Figures for 2025/Q1 are January-February averages.
2. Nondurable goods include goods classified as semi-durable goods in the SNA.

[17] Regarding the CAI, see the Bank's research paper "Revision of the Consumption Activity Index to Capture Recent Changes in Consumption Patterns" released in July 2021.

indicators, statistics published by industry organizations, and anecdotal information from firms, consumption seems to have maintained its moderate increasing trend, particularly in services, reflecting the continued improvement in the income situation, although there continue to be some firms that have pointed to consumers' increased thriftiness due to the rise in food prices (Chart 29).

Chart 29: Consumption Developments Based on Credit Card Spending



Source: Nowcast Inc./ JCB, Co., Ltd., "JCB Consumption NOW."
Notes: 1. Figures are from the reference series in *JCB Consumption NOW*, which take changes in the number of consumers into account.
2. Figures exclude telecommunications and energy (fuel, electricity, gas, heat supply, and water). Based on staff calculations.

By type, consumption of durable goods has been on a moderate increasing trend (Chart 28). Sales of household electrical appliances, especially of heating equipment, have increased. Automobiles sales recently have increased slightly, as progress has been made in reducing order backlogs. Consumption of nondurable goods (e.g., "beverages and food" and "clothes") has continued on a decreasing trend, reflecting consumers' increased thriftiness due to the rise in food prices.

Services consumption has increased moderately (Charts 28 and 29). Dining-out has remained on a moderate increasing trend reflecting the shift to dining-out and the increased sales of high-end services, despite the effects of factors such as shorter operating hours due to labor shortages. Domestic travel has been at a relatively high level. Overseas travel has seen a pause in the recovery, reflecting relatively high travel costs.

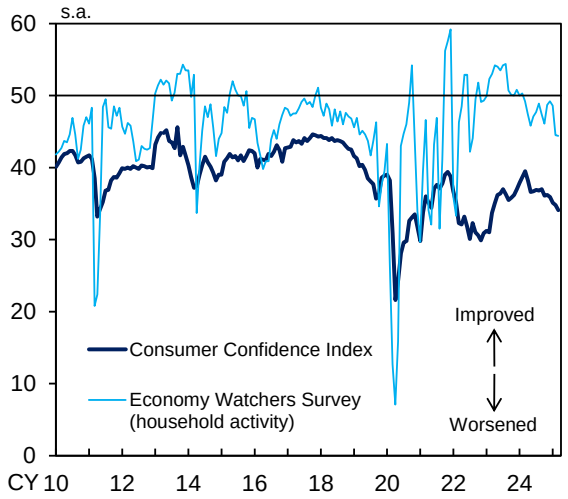
Looking at confidence indicators related to private consumption, both the Consumer Confidence Index in the *Consumer Confidence Survey* -- which asks consumers for their views on the

outlook for the coming six months -- and the current economic conditions DI (household activity-related) of the *Economy Watchers Survey* -- which asks firms for their views on the direction of the economy -- have remained on a deteriorating trend, mainly led by the rise in prices of food, such as rice and fresh food (Chart 30).

Regarding the outlook, although private consumption is expected to continue to be affected by a deterioration in consumer sentiment stemming from the rise in food prices for the time being, it is projected to maintain its moderate increasing trend, as wage increases continue as a result of the annual spring labor-management wage negotiations. Thereafter, although the pace of increase in employee income is likely to slow temporarily, mainly due to weakness in bonuses, private consumption is projected to remain resilient as a trend. Meanwhile, the propensity to consume is likely to be more or less flat, albeit with fluctuations due to the effects of factors such as the tax reform (Chart 31).

Housing investment has been relatively weak (Chart 32). The number of housing starts -- a leading indicator of housing investment -- has followed a downtrend that reflects a rise in housing prices.[18] Housing investment is likely to follow a moderate declining trend due to the rise in housing prices and to a decrease in housing demand reflecting demographic developments, although accommodative financial conditions are expected to provide support.

Chart 30: Confidence Indicators Related to Private Consumption

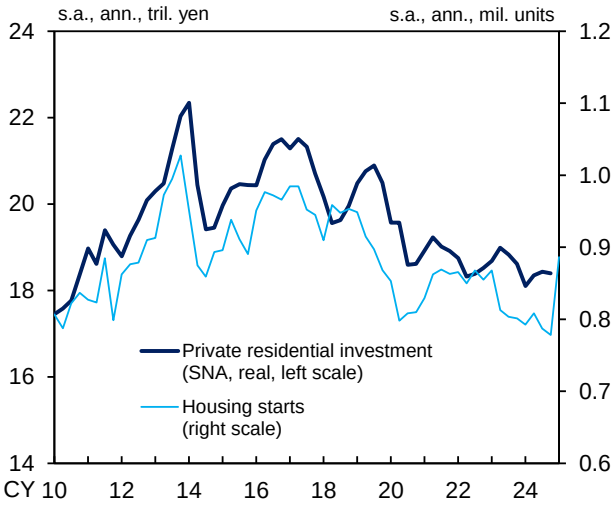


Source: Cabinet Office.
Note: Figures for the *Economy Watchers Survey* are those for the current economic conditions DI.

Chart 31: Average Propensity to Consume

Source: Cabinet Office.
Note: Average propensity to consume = Consumption of households / Disposable income, etc. "Disposable income, etc." consists of disposable income and adjustment for the change in pension entitlements.

Chart 32: Housing Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.

[18] The surge in the number of housing starts for March is likely due to the front-loading prior to the enforcement of the revised Building Standards Act on April 1, 2025.

II. Current Situation of Prices and Their Outlook

Developments in Prices

The quarter-on-quarter rate of increase in the producer price index (PPI, adjusted for the effects of seasonal changes in electricity rates) has been in the range of around 0.5-1.0 percent recently (Chart 33). The year-on-year rate of increase in the services producer price index (SPPI, excluding international transportation) has remained relatively high, being in the range of 3.0-3.5 percent recently, mainly on the back of the rise in personnel expenses.

The year-on-year rate of increase in the CPI (all items less fresh food) has been in the range of 3.0-3.5 percent recently, as moves to pass on wage increases to selling prices have continued, and as there have been effects of the past rise in import prices and of the rise in food prices, such as rice prices (Chart 34). The year-on-year rate of increase in the CPI (all items less fresh food and energy) has accelerated (Chart 35).[19] Specifically, the rate of increase in goods prices has accelerated since summer last year due to the effects of the rise in food prices, such as rice prices. While the rate of increase in general services prices had decelerated, mainly due to a dissipation of the upward pressure on prices brought about by charges for package tours to overseas, more recently, the rate of increase in general services prices has accelerated slightly,

[19] The CPI figures excluding temporary factors are calculated by excluding (1) the effects of the consumption tax hike and policies concerning the provision of free education, (2) the effects of travel subsidy programs, and (3) mobile phone charges from the CPI (all items less fresh food) and the CPI (all items less fresh food and energy).

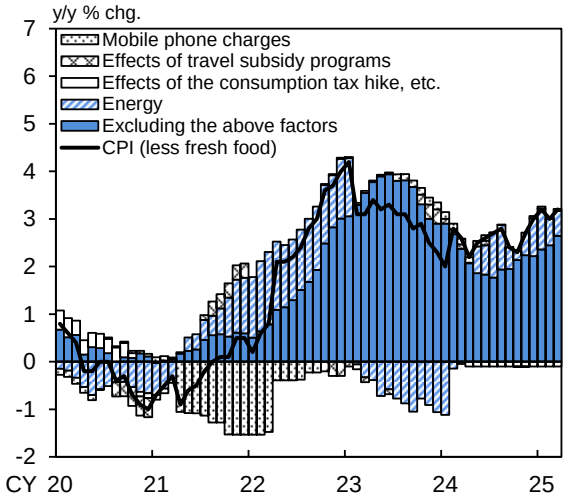
Chart 33: Inflation Indicators

y/y % chg.

	24/Q2	24/Q3	24/Q4	25/Q1
Consumer Price Index (CPI)				
Less fresh food	2.4	2.6	2.6	3.1
Excluding temporary factors	2.4	2.8	2.8	3.2
Less fresh food and energy	2.2	2.0	2.3	2.7
Excluding temporary factors	2.1	2.1	2.5	2.8
Producer Price Index (q/q % chg.)	1.3	0.7	1.1	0.9
Services Producer Price Index	2.8	3.0	3.2	3.2
GDP Deflator	3.1	2.4	2.9	
Domestic demand deflator	2.6	2.2	2.4	

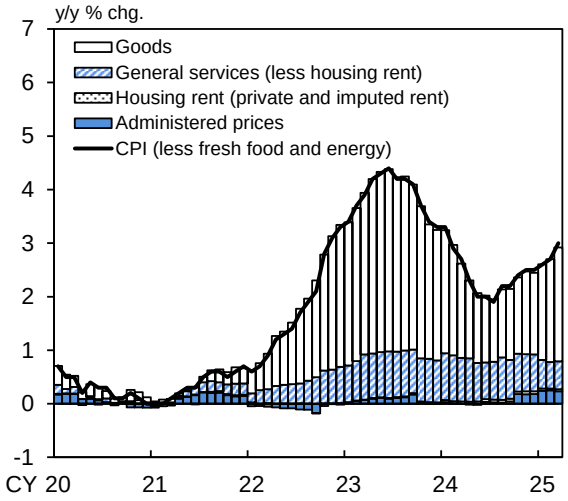
Sources: Ministry of Internal Affairs and Communications; Bank of Japan; Cabinet Office.
Notes: 1. Figures for the producer price index (PPI) are adjusted for the hike in electric power charges during the summer season. Figures for the services producer price index (SPPI) exclude international transportation.
2. The CPI figures excluding temporary factors are staff estimates and exclude mobile phone charges and the effects of policies concerning the provision of free education and travel subsidy programs.

Chart 34: CPI (Less Fresh Food)



Source: Ministry of Internal Affairs and Communications.
Notes: 1. Figures for energy consist of those for petroleum products, electricity, and gas, manufactured & piped.
2. Figures for the "effects of the consumption tax hike, etc." include the effects of policies concerning the provision of free education. The figures from April 2020 onward are staff estimates and include the effects of measures such as free higher education.

Chart 35: CPI (Excluding Temporary Factors)



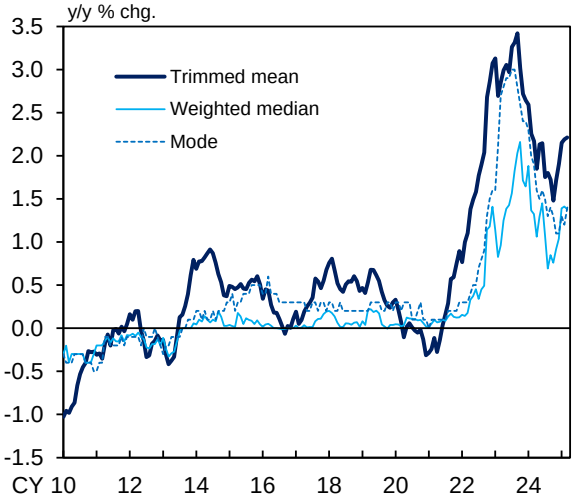
Source: Ministry of Internal Affairs and Communications.
Notes: 1. Administered prices (less energy) consist of "public services" and "water charges."
2. The CPI figures are staff estimates and exclude mobile phone charges and the effects of the consumption tax hike, policies concerning the provision of free education, and travel subsidy programs.

as the effects of the rise in food prices has also been seen in dining-out amid the spread of moves to pass on personnel expenses and other costs to selling prices. The year-on-year rate of change in administered prices has registered a relatively large positive figure, reflecting increases in fire insurance premiums and other prices.

Meanwhile, looking at the CPI (all items less food and energy) -- which is not affected by fluctuations in food and energy prices -- the year-on-year rate of increase has remained more or less flat, at around 1.5 percent.

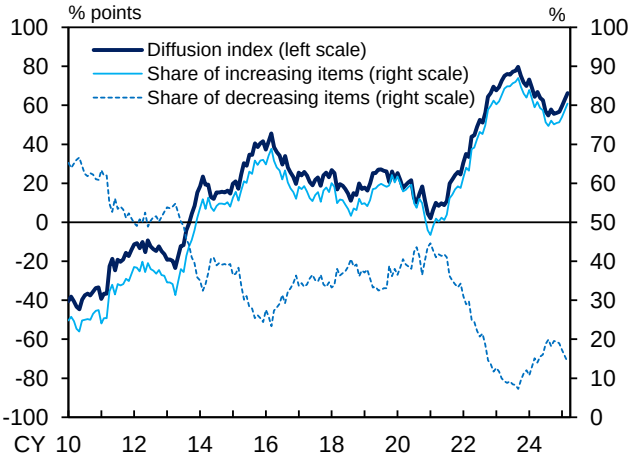
The indicators for capturing the underlying trend in the CPI have exhibited the following developments (Chart 36). [20], [21] The rate of increase in the trimmed mean of the year-on-year rate of change in the CPI has accelerated again since summer last year, and has recently been in the range of 2.0-2.5 percent, as the effects of the rise in food prices, such as rice prices, have been observed in a wide range of items. The rates of

Chart 36: CPI: Trimmed Mean, etc.



Sources: Bank of Japan; Ministry of Internal Affairs and Communications.
Note: Based on staff calculations using the CPI excluding the effects of the consumption tax hikes, policies concerning the provision of free education, and travel subsidy programs. The CPI figures from April 2020 onward are staff estimates and exclude the effects of measures such as free higher education.

Chart 37: Diffusion Index of Price Changes



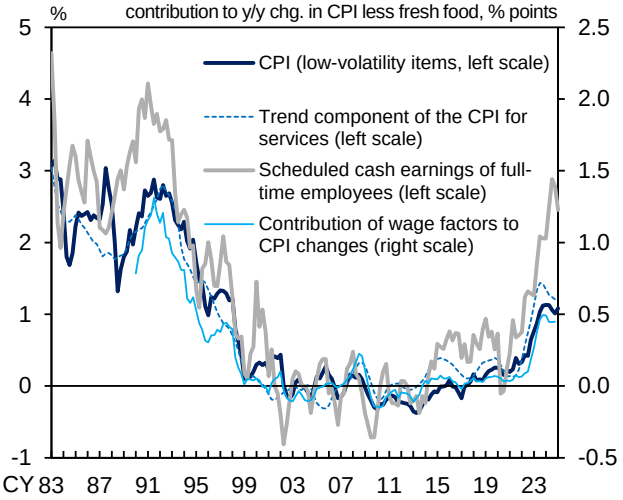
Sources: Bank of Japan; Ministry of Internal Affairs and Communications.
Note: The diffusion index is defined as the share of increasing items minus the share of decreasing items. The share of increasing/decreasing items is the share of items for which price indices increased/decreased from a year earlier. Based on staff calculations using the CPI (less fresh food) excluding the effects of the consumption tax hikes, policies concerning the provision of free education, and travel subsidy programs. The CPI figures from April 2020 onward are staff estimates and exclude the effects of measures such as free higher education.

[20] The trimmed mean is calculated by excluding items that belong to a certain percentage of the upper and lower tails of the price change distribution (10 percent of each tail) in order to eliminate the effects of large relative price changes. The mode is the inflation rate with the highest density in the price change distribution. The weighted median is the average of the inflation rates of the items at around the 50 percentile point of the cumulative distribution in terms of weight. Each indicator is calculated using data for each CPI item that excludes the effects of the consumption tax hikes, policies concerning the provision of free education, and travel subsidy programs.

[21] In this report, the mode is defined as the inflation rate with the highest density in the distribution that is estimated parametrically by fitting a normal inverse Gaussian distribution to the observed price change distribution in each period. It should be noted that, with dispersions of the observed distributions increasing, the fit of the normal inverse Gaussian distribution has deteriorated recently, and therefore, estimates of this mode should be interpreted with some latitude.

increase in the mode and the weighted median also have recently accelerated somewhat, and have both been at around 1.5 percent. Moreover, looking at the year-on-year price changes across all CPI items (less fresh food), the share of items whose prices have increased minus the share of items whose prices have decreased has increased somewhat in positive territory, reflecting a rise in the number of items increasing in price, such as food (Chart 37). Indicators that exclude the impact of fluctuations in import prices in order to capture the inflationary pressure stemming from wage increases have remained on a moderate uptrend (Chart 38).[22] In addition, indicators of inflation expectations, which represent people's perceptions of price developments and are closely related to the underlying inflation trend, have increased moderately, as described below.[23]

Chart 38: CPI Changes due to Wage Factors



Sources: Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare; Bank of Japan.

Notes: 1. Figures for low-volatility CPI items and scheduled cash earnings of full-time employees are year-on-year percentage changes, while those for the trend component of the CPI for services are the 6-quarter backward moving averages of annualized quarter-on-quarter percentage changes. Figures for scheduled cash earnings of full-time employees before 1994 are those for regular employees. Moreover, figures from 2016 onward are based on continuing observations following the sample revisions.

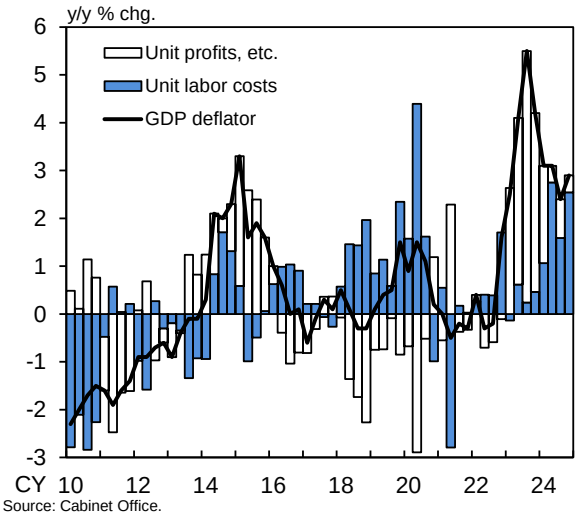
2. Figures for the contribution of wage factors to CPI changes are based on the relationship between the CPI and wages, estimated using a 4-variable VAR model comprising import prices (yen basis), the output gap, wages (scheduled cash earnings of full-time employees), and price indices for low-, medium-, and high-volatility items in the CPI. The estimates are obtained using 20-year rolling regressions for low-, medium-, and high-volatility CPI items.

3. Figures for the trend component of the CPI for services are the composite of the sector-specific price trend for services and the common trend in services prices and wages. The figures are estimated using category-level services prices and industry-level scheduled cash earnings.

4. The figure for scheduled cash earnings of full-time employees for 2025/Q1 is the January-February average.

Meanwhile, decomposing changes in the GDP deflator into the contribution of changes in unit labor costs and changes in unit profits and other factors shows that the acceleration in the rate of increase in the GDP deflator observed in 2023 was mainly due to an increase in unit profits, as firms passed on cost increases (Chart 39). Although the rate of increase in the GDP deflator has decelerated since the start of 2024, the

Chart 39: GDP Deflator



Source: Cabinet Office.

Note: Unit labor costs = Nominal compensation of employees / Real GDP

[22] For details, see "Recent Developments in the Linkage between Wages and Prices," *Bank of Japan Review Series*, no. 24-E-2, May 2024.

[23] Since 2022, indicators such as the trimmed mean have risen sharply since prices of an extremely wide range of items have shown large increases in the wake of the rise in import prices. For this reason, in the current phase, it is important to examine a wider range of indicators to grasp underlying inflation trends excluding factors such as temporary fluctuations in raw material prices. For details, see Box 4 in the April 2024 Outlook Report.

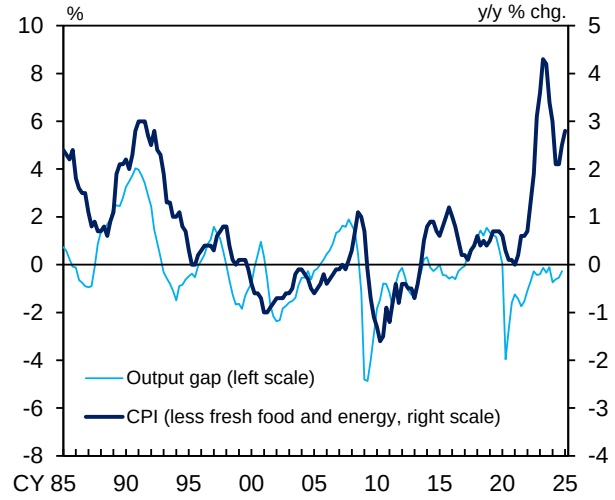
positive contribution of unit labor costs has been intensifying in reflection of wage increases.

Environment Surrounding Prices

In the outlook for prices, the main factors that determine inflation rates are assessed as follows. First, the output gap is likely to temporarily widen in negative territory during fiscal 2025, reflecting a decline in the capacity utilization rate for the manufacturing industry; thereafter, toward the end of the projection period, the gap is likely to improve gradually (Charts 2 and 40). Meanwhile, it is likely that labor market conditions have tightened to a greater extent than can be explained by the changes in the output gap, due to a deceleration in the pace of increase in labor force participation of women and seniors and to a tightening of regulations on working hours. In this situation, upward pressure on wages and prices is more likely to be stronger than suggested by the output gap, given the current situation that labor shortages have begun to constrain the economic activity of firms, mainly in the nonmanufacturing industry, from the supply side.

Second, medium- to long-term inflation expectations have risen moderately (Chart 41). Regarding the outlook, although it is projected that firms will maintain their active wage- and price-setting behavior and will continue their moves to reflect higher costs -- including increased personnel expenses and distribution costs -- in selling prices, inflation expectations are expected to be sluggish, mainly due to the deceleration in the economy. Thereafter, as the economic growth rate rises and labor market conditions tighten notably, it is expected that

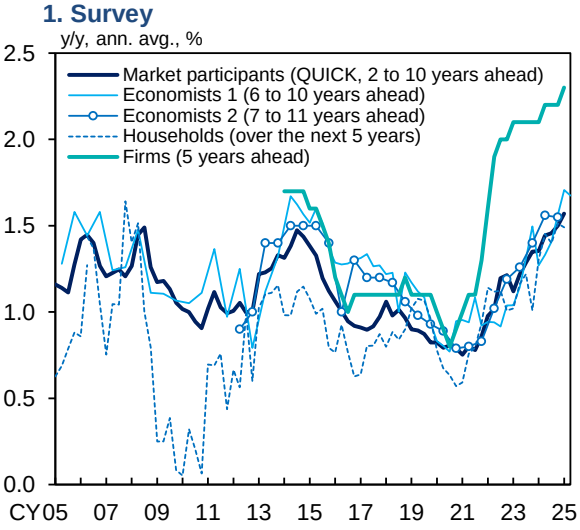
Chart 40: Inflation Rate and Output Gap



Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
Notes: 1. The CPI figures are staff estimates and exclude mobile phone charges and the effects of the consumption tax hikes, policies concerning the provision of free education, and travel subsidy programs.
2. Figures for the output gap are staff estimates.

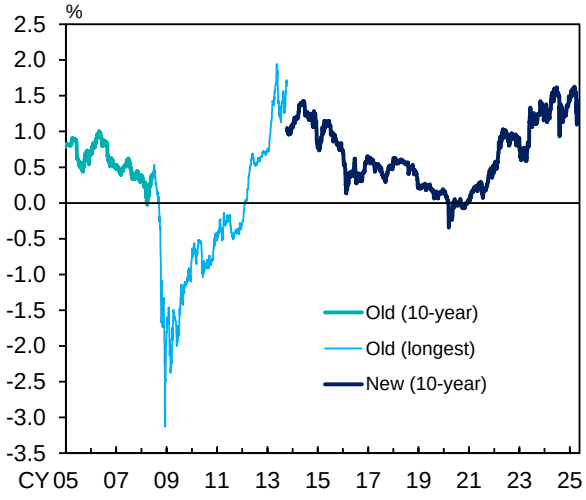
Chart 41: Inflation Expectations

1. Survey



Sources: Bank of Japan; QUICK, "QUICK Monthly Market Survey <Bonds>"; JCER, "ESP Forecast"; Consensus Economics Inc., "Consensus Forecasts."
Notes: 1. "Economists 1" shows the forecasts of economists in the *Consensus Forecasts*. "Economists 2" shows the forecasts of forecasters surveyed for the *ESP Forecast*.
2. Figures for households are from the *Opinion Survey on the General Public's Views and Behavior*, estimated using the modified Carlson-Parkin method for a 5-choice question.
3. Figures for firms show the inflation outlook of enterprises for general prices (all industries and enterprises, average) in the *Tankan*.

2. BEI



Source: Bloomberg.
Note: The BEI (break-even inflation) rate is the yield spread between fixed-rate coupon-bearing JGBs and inflation-indexed JGBs. Inflation-indexed JGBs issued since October 2013 are designated as "new," while the rest are designated as "old." Figures for "old (longest)" are calculated using yield data for issue No. 16 of inflation-indexed JGBs, which matured in June 2018.

firm's active wage- and price-setting behavior will become more widespread, and that inflation expectations will rise moderately again.

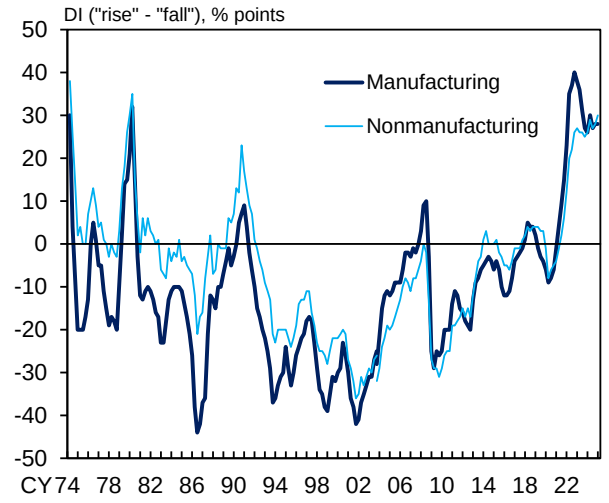
Third, the import price index on a contract currency basis has been more or less flat, reflecting past developments in international commodity prices. On the other hand, developments in foreign exchange rates have led the index on a yen basis to rise in early autumn last year and then decrease somewhat more recently (Charts 43 and 44).

Meanwhile, the year-on-year rate of change in energy prices (e.g., gasoline prices and electricity charges) has been positive, pushing up the year-on-year rate of increase in the CPI (all items less fresh food) by around 0.5 percentage points. If foreign exchange rates and crude oil prices are assumed to be at around the current levels, given the government's measures to reduce the household burden of higher gasoline and other prices, the rate of increase in energy prices is likely to be at around 0 percent, albeit with fluctuations.

Outlook for Prices

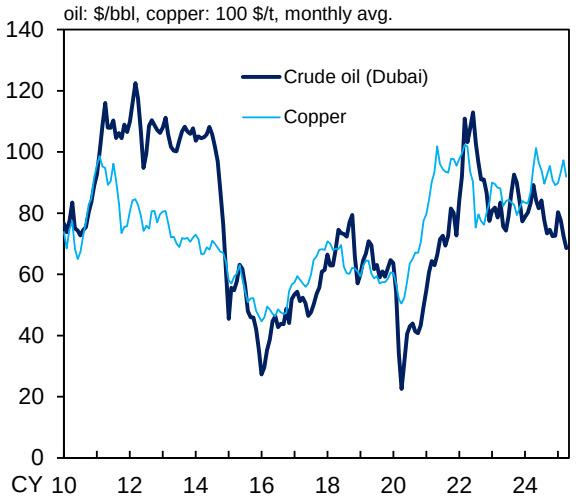
Based on this underlying scenario, the year-on-year rate of increase in the CPI (all items less fresh food and energy) is likely to be temporarily below 2 percent because it is expected that the effects of the past rise in import prices and of the recent rise in food prices, such as rice prices, will gradually wane and that this CPI will be affected by factors such as the deceleration in the economy. Thereafter, however,

Chart 42: Output Prices



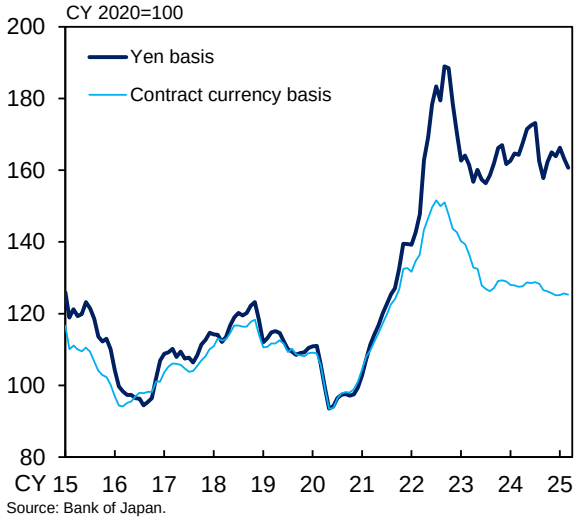
Source: Bank of Japan.
Note: Based on the *Tankan*. All enterprises. There is a discontinuity in the data for December 2003 due to a change in the survey framework.

Chart 43: International Commodity Prices



Sources: Nikkei Inc.; Bloomberg.

Chart 44: Import Price Index



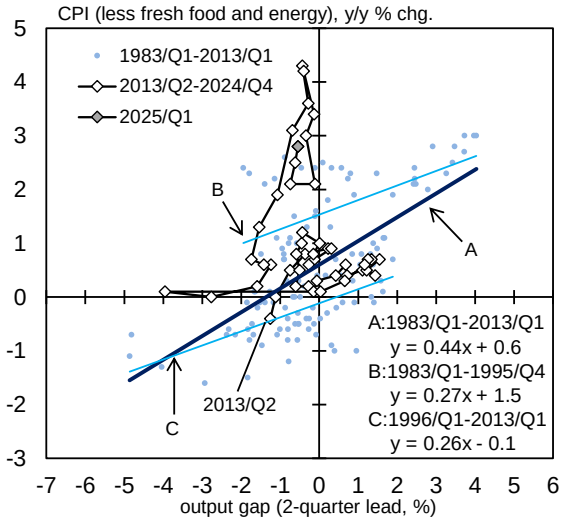
Source: Bank of Japan.

the rate of increase in this CPI is likely to be at around 2 percent as the economic growth rate rises (Chart 45).

The year-on-year rate of increase in the CPI (all items less fresh food) is likely to be in the range of 2.0-2.5 percent for fiscal 2025, in the range of 1.5-2.0 percent for fiscal 2026, and at around 2 percent for fiscal 2027. The effects of the past rise in import prices and of the recent rise in food prices such as rice prices -- these factors have pushed up the inflation rate so far-- are expected to wane. Meanwhile, underlying CPI inflation is likely to be sluggish, mainly due to the deceleration in the economy. Thereafter, however, underlying CPI inflation is expected to increase gradually, since it is projected that a sense of labor shortage will grow as the economic growth rate rises, and that medium- to long-term inflation expectations will rise. In the second half of the projection period, underlying CPI inflation is likely to be at a level that is generally consistent with the price stability target.

Firms' behavior has shifted more toward raising wages and prices, and it is expected in the baseline scenario that this trend will be maintained, despite the deceleration in the economy. However, a prolonged period of high uncertainties regarding trade and other policies in each jurisdiction could lead firms to focus more on cost cutting. As a result, moves to reflect price rises in wages could also weaken. On the other hand, moves to reflect wages in selling prices could strengthen to a greater extent than expected, and upward pressure on wages could

Chart 45: Phillips Curve



Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
Notes: 1. The CPI figures are staff estimates and exclude mobile phone charges and the effects of the consumption tax hikes, policies concerning the provision of free education, and travel subsidy programs.
2. Figures for the output gap are staff estimates.

intensify with growing expectations that labor market conditions will continue to be tight.

III. Financial Developments in Japan

Financial Conditions

Financial conditions have been accommodative.

Looking at short-term interest rates, the uncollateralized overnight call rate has been at around 0.5 percent, as the policy interest rate was raised at the January 2025 Monetary Policy Meeting (Chart 46). Regarding interest rates on term instruments, both the 3-month TIBOR and the 3-month treasury discount bill (T-Bill) rate have risen.

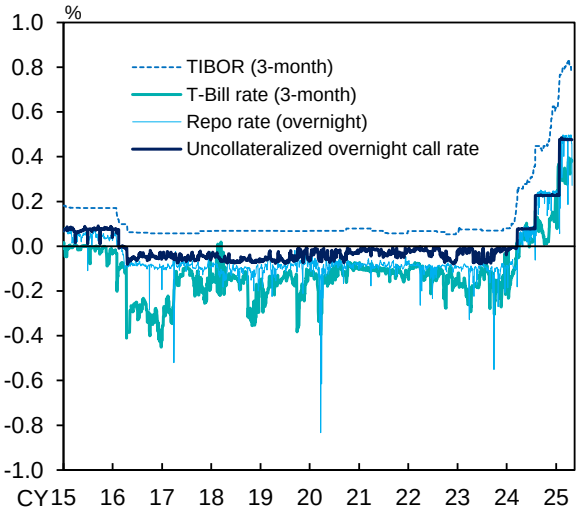
Real interest rates have been negative (Chart 47).[24]

Firms' funding costs have increased (Chart 48). Lending rates (the average interest rates on new loans and discounts) have risen for both long-term and short-term ones, due to rises in market interest rates and short-term prime rates, both of which serve as base rates. Issuance rates for CP have increased, in tandem with the rise in short-term interest rates. Issuance rates for corporate bonds have risen, reflecting the increase in their base rate.

The DI in the *Tankan* for financial institutions' lending attitudes as perceived by firms suggests that such attitudes have remained accommodative on the whole (Chart 49). The DI for issuance conditions for CP has continued to

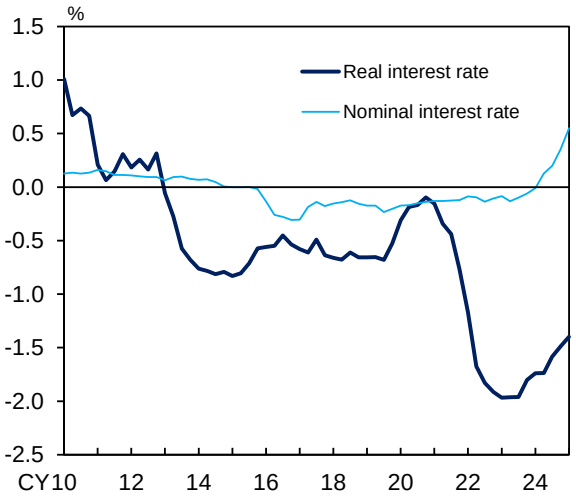
[24] See Box 5 of the April 2024 Outlook Report for an assessment of financial conditions in terms of real interest rates.

Chart 46: Short-term Interest Rates



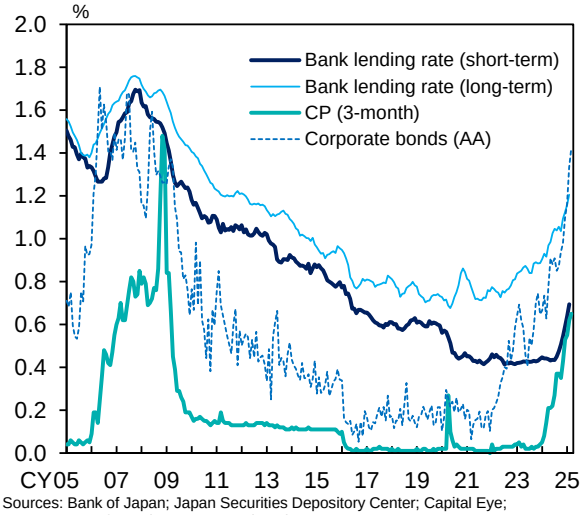
Sources: Bank of Japan; JBA TIBOR Administration; Bloomberg.
Note: Figures for repo rate are the *Tokyo Repo Rate*.

Chart 47: Real Interest Rate (1-Year)



Sources: Bank of Japan; QUICK, "QUICK Monthly Market Survey <Bonds>"; Consensus Economics Inc., "Consensus Forecasts"; Bloomberg.
Note: Figures for the real interest rate are calculated as government bond yields (1-year) minus the composite index of inflation expectations (staff estimates).

Chart 48: Bank Lending Rates and Issuance Yields for CP and Corporate Bonds

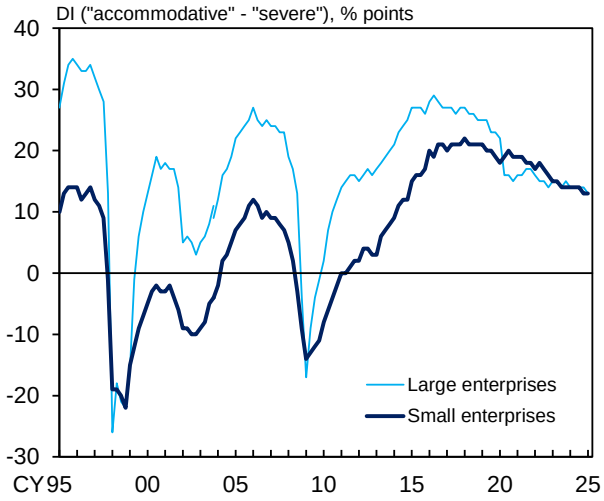


Sources: Bank of Japan; Japan Securities Depository Center; Capital Eye; I-N Information Systems; Bloomberg.
Notes: 1. Figures for issuance yields for CP up through September 2009 are the averages for CP (3-month, rated a-1 or higher). Those from October 2009 onward are the averages for CP (3-month, rated a-1).
2. Figures for issuance yields for corporate bonds are the averages for domestically issued bonds launched on a particular date. Bonds issued by banks and securities companies, etc. are excluded.
3. Figures for bank lending rates are 6-month backward moving averages.

show net "easy" conditions. As suggested by the latter, issuance conditions for CP have been favorable. In the corporate bond market, issuance conditions have remained favorable on the whole, although a widening of issuance spreads has been seen in part and some firms have delayed issuance of bonds since the turn of April, reflecting factors such as the increased volatility in the market. Meanwhile, the DI for firms' financial positions in the *Tankan* suggests that they have been at favorable levels on the back of the recovery in economic activity and progress in the pass-through of cost increases to selling prices (Chart 50).

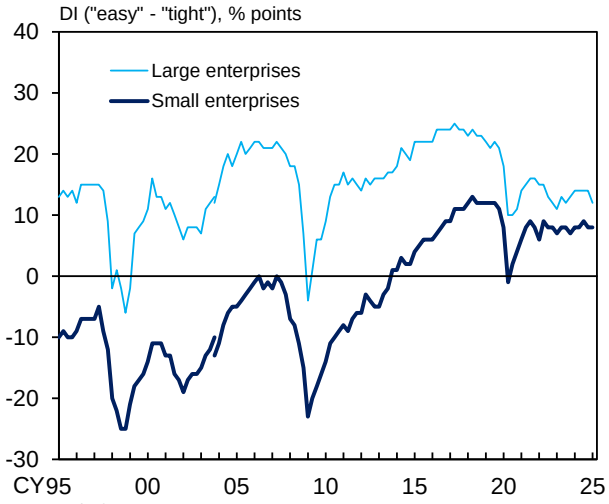
Firms' demand for funds has increased moderately on the back of, for example, the recovery in economic activity as well as mergers and acquisitions of firms. In this situation, the year-on-year rate of increase in the amount outstanding of bank lending has been at around 3 percent (Chart 51). The year-on-year rate of increase in the aggregate amount outstanding of CP and corporate bonds has been in the range of 4.5-5.0 percent.

Chart 49: Lending Attitudes of Financial Institutions as Perceived by Firms



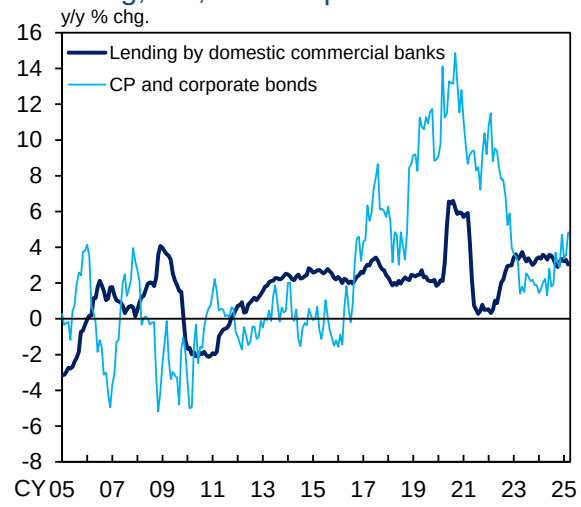
Source: Bank of Japan.
Note: Based on the *Tankan*. All industries. There is a discontinuity in the data for December 2003 due to a change in the survey framework.

Chart 50: Firms' Financial Positions



Source: Bank of Japan.
Note: Based on the *Tankan*. All industries. There is a discontinuity in the data for December 2003 due to a change in the survey framework.

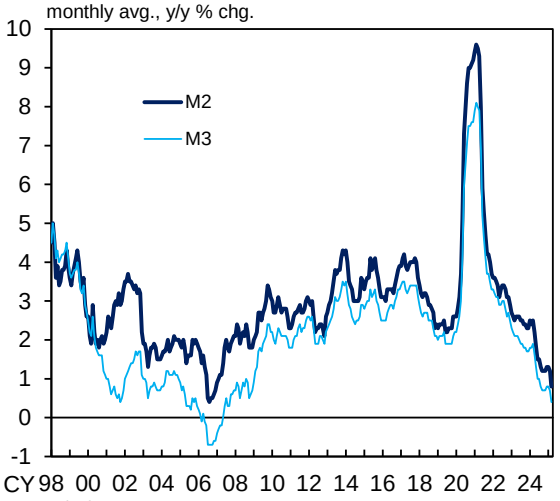
Chart 51: Amounts Outstanding of Bank Lending, CP, and Corporate Bonds



Sources: Bank of Japan; Japan Securities Depository Center; Japan Securities Dealers Association; I-N Information Systems.
Note: Figures for lending by domestic commercial banks are monthly averages. Figures for CP and corporate bonds are those at the end of the period.

The year-on-year rate of change in the money stock (M2) has been in the range of 0.5-1.0 percent, as the amount outstanding of bank lending has continued to increase and fiscal spending has kept pushing the rate up (Chart 52).

Chart 52: Money Stock

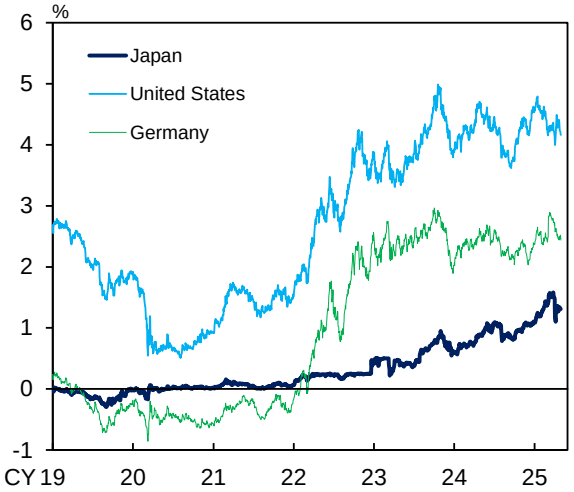


Source: Bank of Japan.

Developments in Financial Markets

In global financial markets, market sentiment tuned highly cautious between the end of March and early April due to heightened uncertainties regarding the future course and impact of trade and other policies in each jurisdiction. Although market sentiment subsequently improved temporarily reflecting factors such as a pause in the introduction of some tariffs, global financial markets have continued to see large fluctuations, as market participants have been paying strong attention to uncertainties over the outlook for the global economy.

Chart 53: 10-Year Government Bond Yields in Selected Advanced Economies

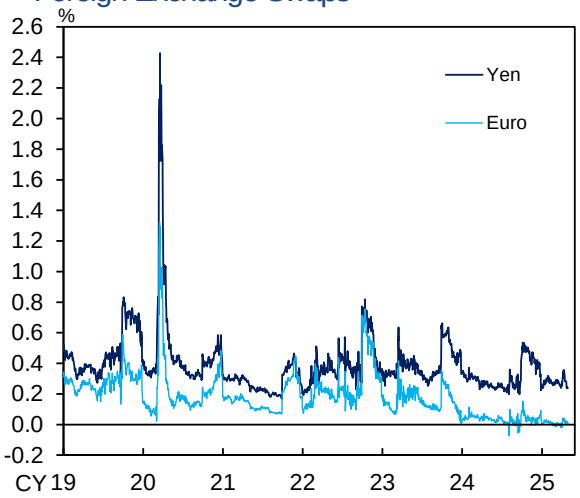


Source: Bloomberg.

With heightened uncertainties regarding trade and other policies in each jurisdiction, yields on 10-year government bonds in the United States declined significantly through early April, mainly due to the rise in investors' risk aversion and the increase in market expectations for policy interest rate cuts by the Federal Reserve. Since then, 10-year yields in the United States have seen large fluctuations (Chart 53). Yields on 10-year government bonds in Europe had increased, mainly because vigilance against a deterioration in supply and demand conditions in sovereign bonds heightened. However, since April, 10-year yields in Europe have declined, with heightened uncertainties regarding trade and other policies in each jurisdiction. In Japan, yields on 10-year government bonds had risen against the background of factors such as generally solid economic indicators and the resultant change in market views on the Bank of Japan's future monetary policy. More recently, 10-year yields in Japan have seen large fluctuations, like those in the United States and Europe.

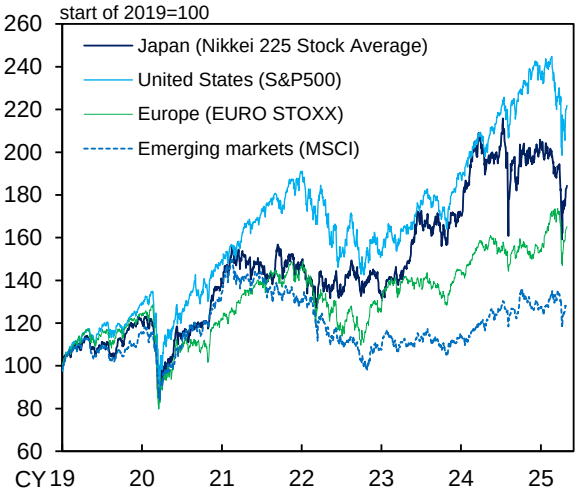
Premiums for U.S. dollar funding through the dollar/yen foreign exchange swap market have generally been at low levels, although they temporarily widened somewhat when market sentiment became cautious (Chart 54).

Chart 54: Dollar Funding Premiums through Foreign Exchange Swaps



Source: Bloomberg.
Notes: 1. U.S. dollar funding premiums are calculated as the difference between U.S. dollar fundings rates (3-month) in the dollar/yen or euro/dollar foreign exchange swap market and those in the money market.
2. The interest rates used for the calculation are as follows: for the yen, the OIS rate; for the euro, the EONIA-referencing OIS rate before October 4, 2019, and the €STR-referencing OIS rate thereafter; for the U.S. dollar, the OIS rate before January 3, 2019, and the SOFR thereafter.

Chart 55: Selected Stock Price Indices



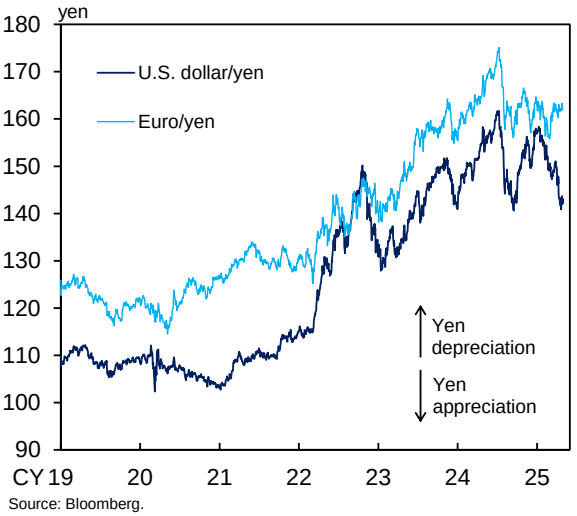
Source: Bloomberg.
Note: Figures for emerging markets are those for the MSCI Emerging Markets Index (local currency).

Stock prices in the United States, amid sluggish prices of major high-tech stocks that had led the rise in U.S. stock prices, declined significantly in the period through early April, as uncertainties regarding trade and other policies in each jurisdiction heightened. Thereafter, U.S. stock prices rebounded, such as when a pause in the introduction of some tariffs was announced, but they have continued to see large fluctuations, with markets paying strong attention to uncertainties over the outlook for the global economy (Chart 55). In Europe, with markets focusing on the low valuation of stock prices in Europe compared to those in the United States, stock prices had risen, mainly because firms' business performance was more favorable than markets had expected. However, since April, stock prices in Europe have seen large fluctuations, moving in line with those in the United States. Stock prices in Japan have been moving generally in line with those in the United States: they were more or less flat through mid-February and have seen large fluctuations since then. Meanwhile, stock prices in emerging economies have seen large fluctuations, like stock prices in advanced economies.

In foreign exchange markets, the yen has appreciated against the U.S. dollar, albeit with large fluctuations, as global investors' risk aversion has heightened and attention has focused on factors such as the yield differential

between Japan and the United States (Chart 56). The euro/yen exchange rate has generally been more or less flat, albeit with fluctuations.

Chart 56: U.S. Dollar/Yen and Euro/Yen

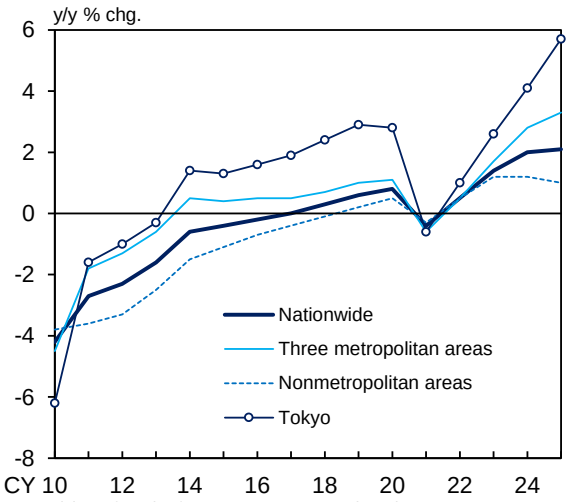


Source: Bloomberg.

Land Prices

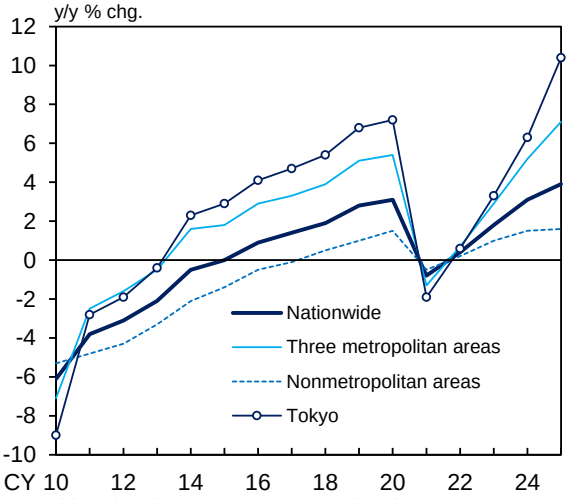
Land prices have increased, reflecting the economic recovery. According to the *Land Market Value Publication* for 2025 (as of January 1), the year-on-year rates of increase in both residential and commercial land prices have accelerated (Charts 57 and 58). In the three major metropolitan areas (Tokyo, Osaka, and Nagoya), the year-on-year rates of increase in both residential and commercial land prices have accelerated. In nonmetropolitan areas, the rate of increase in residential land prices has decelerated, while the rate of increase in commercial land prices has accelerated.

Chart 57: Residential Land Prices



Source: Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. Based on the *Land Market Value Publication*. Figures are as of January 1.
2. The three metropolitan areas are the Tokyo area (Tokyo, Kanagawa, Saitama, Chiba, and Ibaraki prefectures), the Osaka area (Osaka, Hyogo, Kyoto, and Nara prefectures), and the Nagoya area (Aichi and Mie prefectures). Nonmetropolitan areas are areas other than the three metropolitan areas.

Chart 58: Commercial Land Prices



Source: Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. Based on the *Land Market Value Publication*. Figures are as of January 1.
2. The three metropolitan areas are the Tokyo area (Tokyo, Kanagawa, Saitama, Chiba, and Ibaraki prefectures), the Osaka area (Osaka, Hyogo, Kyoto, and Nara prefectures), and the Nagoya area (Aichi and Mie prefectures). Nonmetropolitan areas are areas other than the three metropolitan areas.

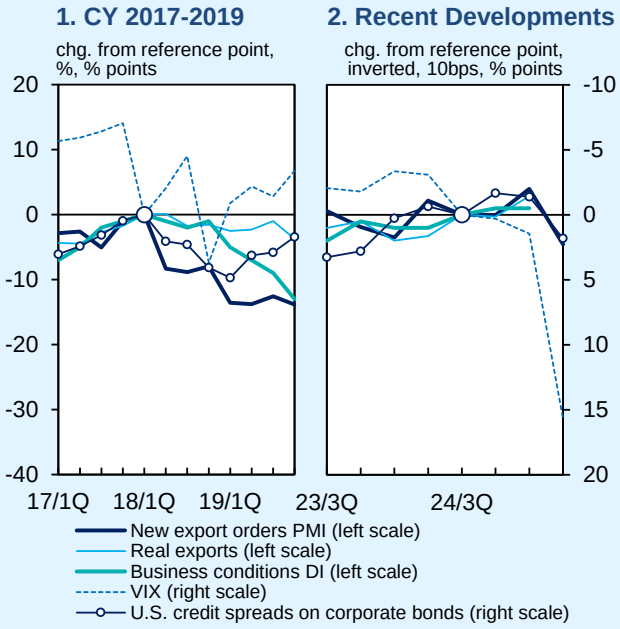
(Box 1) Situation surrounding Trade Policies and Its Impact

This box summarizes developments in trade policies and their potential impact on Japan's economic activity and prices.

Looking back at developments in trade policies over the past several years, the U.S. administration imposed tariffs on imports from China of around 20 percent in the period between 2018 and the beginning of 2020. Similarly, China raised tariffs on imports from the United States. Under the current U.S. administration, a series of policies has come into effect, and others are being considered, that include (1) reciprocal tariffs, imposing additional tariffs on all countries and regions and country-specific tariff rates; and (2) sectoral tariffs on selected items such as steel and aluminum, automobiles and auto parts, semiconductors, and pharmaceuticals.

In terms of the impact of trade frictions between the United States and China on Japan's economy during the period between 2017 and 2019, Japan's new export orders PMI and the business conditions DI from the *Tankan* deteriorated, but the actual decline in exports was limited (Chart B1-1[1]). The background to this may be that, although exports from Japan to China decreased as exports from China to the United States did so, Japanese exports were underpinned by a shift in demand to Japanese products (a shift from Chinese products to Japanese products) and by demand induced by shifts to other countries (an increase in demand for Japanese products

Chart B1-1: Corporate Indicators



Sources: Bloomberg; ICE Data Indices, LLC; Copyright © 2025 by S&P Global Market Intelligence, a division of S&P Global Inc. All rights reserved; Ministry of Finance; Bank of Japan.
Notes: 1. The business conditions DI is based on the *Tankan* (all enterprises). Figures for the new export orders PMI are the au Jibun Bank Japan Manufacturing PMI (new export orders PMI). Figures for U.S. credit spreads on corporate bonds are those for BBB-rated ones.
2. Figures are the averages of each quarter. The reference points in the left- and right-hand charts are 2018/Q1 and 2024/Q3, respectively.
3. The figure for the new export orders PMI for 2025/Q2 is that for April.

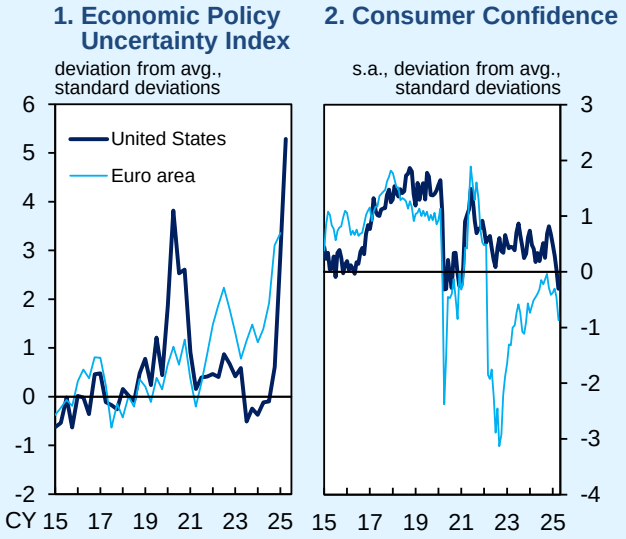
reflecting a shift from Chinese products to products made in other countries).[25]

In the current phase, financial markets have shown unstable developments, such as a recent rapid rise in VIX reflecting growing uncertainties surrounding U.S. trade policies, the response of other countries, and concerns over a slowdown in the global economy (Charts B1-1[2] and B1-2[1]). In the United States, consumer confidence has recently deteriorated, mainly due to the aforementioned increased volatility in the stock market and concerns over rising inflation stemming from the rise in import prices (Chart B1-2[2]).

Some basic facts about Japan-U.S. trade relations are as follows. Among the countries and regions that the United States has trade deficits with, Japan ranks 6th in terms of the size of the deficit, as of 2024, with the top three deficits being with China, the EU, and Mexico (Chart B1-3). Japan's trade statistics show that the total volume of exports from Japan to the United States in 2024 was 21.3 trillion yen, or 3.5 percent of Japan's nominal GDP. The value of automobile-related exports from Japan to the United States was about 7.6 trillion yen in 2024, or 1.3 percent of Japan's nominal GDP, with the majority of these exports being high value-added motor vehicles, on which an additional 25 percent U.S. tariff has been imposed (Chart B1-4). In addition, imports of automobile-related goods to the United States by country of origin shows that Mexico is the largest

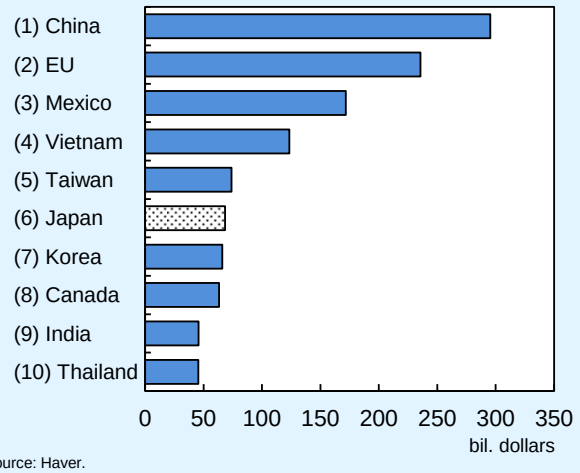
[25] Fajgelbaum et al. (2024), "The US-China Trade War and Global Reallocations," *American Economic Review: Insights*, vol. 6, no. 2, pp. 295-312.

Chart B1-2: Economic Policy Uncertainty and Consumer Confidence



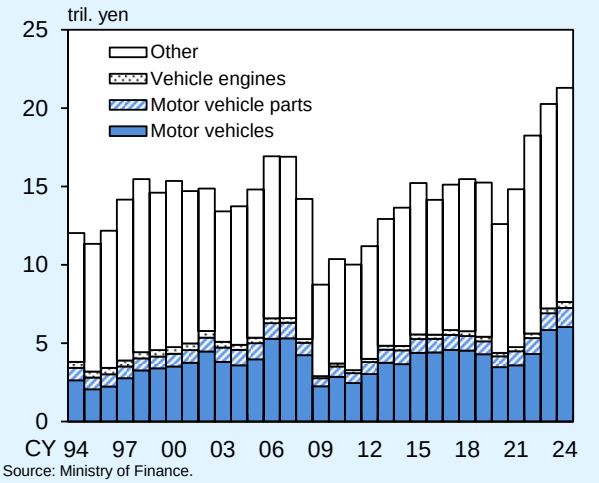
Sources: Haver; Economic Policy Uncertainty.
Notes: 1. Figures are normalized using the average and standard deviation for the period from 2001 onward.
2. In the left-hand chart, the figure for the United States for 2025/Q2 is that for April (calculated using daily data). Figures for the euro area are the averages of those for Germany, France, Italy, and Spain.
3. In the right-hand chart, figures for the United States are from the Conference Board. Those for the euro area are from the European Commission.

Chart B1-3: U.S. Trade Deficit (Top 10 Countries and Regions)



Source: Haver.
Note: Figures are for CY 2024.

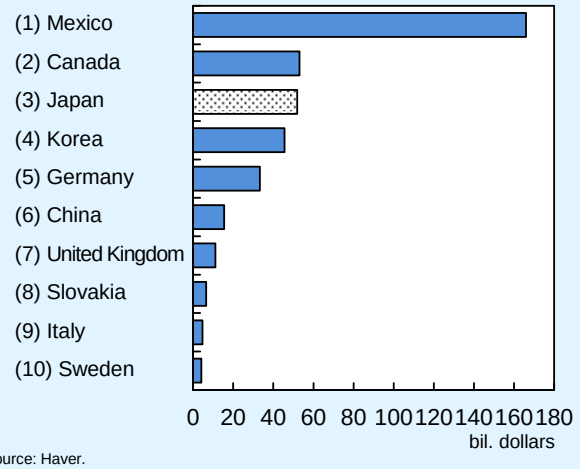
Chart B1-4: Exports from Japan to the United States



Source: Ministry of Finance.

(about 165.9 billion dollars), followed by Canada (about 53.1 billion dollars), and Japan (about 51.9 billion dollars) (Chart B1-5). Attention should also be paid to the fact that U.S. automobile-related imports from Mexico and Canada include products manufactured by Japanese automakers in their factories located in Mexico and Canada, which are then exported to the United States.

Chart B1-5: U.S. Automobile Imports (Top 10 Countries)



Source: Haver.
Note: Figures are for CY 2024. Figures consist of motor vehicles and motor vehicle parts.

Drastic changes to trade policies in various countries could affect Japan's economy through several channels. First, a rapid heightening of uncertainties has a negative impact on Japan's capital goods exports, through stagnant global demand for business fixed investment, and exerts downward pressure on domestic demand through postponement of consumption of durable goods and business fixed investment.

Second, U.S. tariff hikes deteriorate price competitiveness of exported goods from Japan against, for example, similar goods produced domestically within the United States. In general, if Japanese exporting firms facing tariff hikes decide to keep local prices in the United States unchanged and not to pass on the impact of tariffs, this will exert downward pressure directly on the profits of those firms. On the other hand, if Japanese exporting firms pass on the impact of tariff increases to local prices and the exported goods have high substitutability with U.S. products, or if these Japanese firms lose market share to other countries with limited price increases, then Japan's export volume will decrease.[26] Such a decline in export volume is

[26] As an increase in tariffs changes the relative price of tradable

likely to have a downward effect on Japan's production, including spillover effects to related industries.

Third, a deceleration in the global economy, or a decrease in global trade activity, could exert downward pressure on Japan's real exports. On this point, the implementation of global reciprocal tariffs, additional country-specific reciprocal tariffs -- which are set at high levels for Asian countries -- and sectoral tariffs on items such as semiconductors could pose a risk to Japan's exports. This warrants close attention, as Japan's exports may be pushed down further through adverse effects on trade activity in East Asia, which has strong economic ties with Japan through supply chains, and the global cycle for IT-related goods.

Fourth, profits of overseas subsidiaries of Japanese firms are highly likely to be pushed down by tariff hikes and the subsequent decline in global trade activity. In that case, there would be a negative impact on firms' current profits through a decrease in receipts from direct investment income.

In terms of the impact on inflation, prices in Japan could be affected through import prices if foreign exchange rates fluctuate considerably due to tariff policies. A decline in demand mainly for exports and business fixed investment is considered to push down prices (Chart B1-6). However, if global

Chart B1-6: Impact on Japan's Economic Activity and Prices

Channel	GDP	Inflation
(1) Weaker global demand	↓	↓
(2) Decrease in exports	↓	↓
(3) Decrease in corporate profits	↓	↓
(4) Exchange rate fluctuations	↑↓	↑↓
(5) Supply-chain disruptions, etc.	↓	↑

goods, a mechanism of expenditure switching operates -- imports from a country in which relative prices have risen could decline, and vice versa.

production systems are disturbed due to stagnation in trade activity and supply-chain disruptions, Japan's prices may be pushed up, mainly through a rise in import prices.

As described above, there may be various transmission channels for the impact of trade policies in various countries. The Bank will continue to carefully examine the impact on Japan's economic activity and prices using the network of the Head Office, branches, and local and overseas offices.

(Box 2) Productivity Trends in Japan

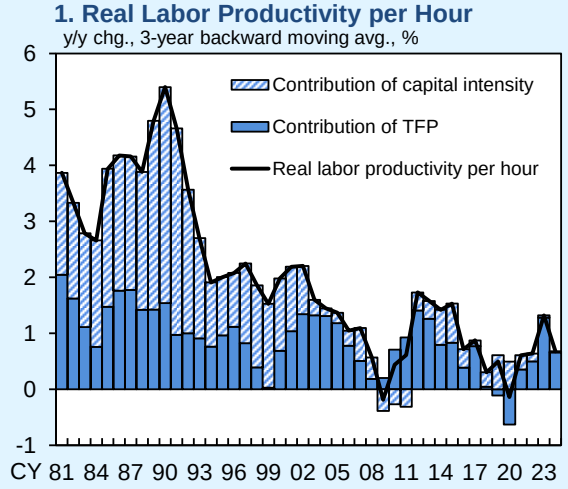
This box examines productivity trends in Japan's economy in recent years and the factors affecting them.

Japan's real labor productivity per hour has been rising at a year-on-year rate of about 1 percent after having plunged during the COVID-19 pandemic. In Chart B2-1(1), factors affecting real labor productivity per hour are decomposed into the contributions of capital intensity and total factor productivity (TFP). In recent years, the contribution of increases in capital intensity has become smaller than during the 1980s and 1990s, and a rise in TFP has been the main factor pushing up labor productivity. Furthermore, the decomposition of TFP growth by sector indicates that while the contribution of the IT-producing sector has been shrinking, that of the IT-using sector, including transport, wholesale and retail trade, and chemicals, as well as of the "other" sector (including transport equipment), has recently been pushing up overall TFP (Chart B2-1[2]).[27] An increase in investment in intangible assets can be pointed to as background to the productivity growth in these sectors.

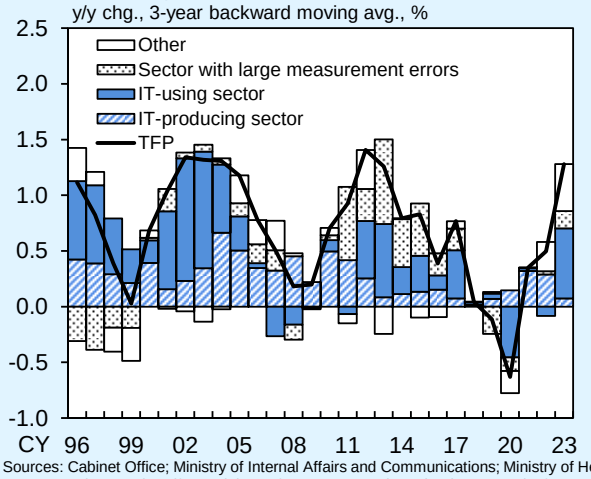
Of intangible asset investment, software investment has been on a long-term increasing trend. In the recovery phase from the COVID-19 pandemic, the increase is particularly evident in

Chart B2-1: Real Labor Productivity and TFP

1. Real Labor Productivity per Hour



2. TFP by Sector



Sources: Cabinet Office; Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare; Ministry of Economy, Trade and Industry; Bank of Japan.

Notes: 1. In the upper chart, figures for the contribution of TFP are staff estimates and adjusted for capital utilization rates. Figures for the contribution of capital intensity are calculated as the difference between the real labor productivity per hour and the contribution of TFP.

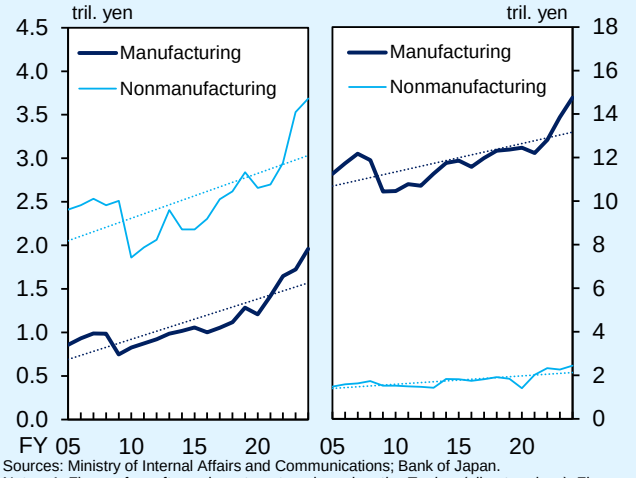
2. In the lower chart, sectors are classified based on the ratio of software investment to value added and other factors, following Fernald, J. (2015), "Productivity and Potential Output before, during, and after the Great Recession," *NBER Macroeconomics Annual 2014*, vol. 29.
IT-producing sector: electronic components and devices; electrical machinery, equipment and supplies; information and communication electronics equipment.
IT-using sector: wholesale and retail trade; accommodation and food service activities; transport and postal services; professional, scientific and technical activities; information and communications; chemicals, etc.
Sector with large measurement errors: finance and insurance; real estate; construction; mining.
Other: transport equipment; general-purpose, production and business oriented machinery; food products and beverages; basic metal; fabricated metal products, etc. (excluding education; human health and social work activities; public administration, etc.).

[27] Using the value-added ratio of software investment as a variable illustrating the degree of IT use for each sector, industries with a high value-added ratio were classified as the IT-using sector. For details, see Box 2 of the April 2017 Outlook Report.

nonmanufacturing (Chart B2-2[1]). The increase in nonmanufacturing appears to be attributable to labor-saving-related software investment that has been on the rise due to severe labor shortages. Research and development (R&D) investment has also followed a long-term increasing trend, with the increase in R&D investment in manufacturing being particularly notable of late (Chart B2-2[2]). In manufacturing, particularly the automobile and chemical industries, the increase in R&D investment may be attributed to efforts to address environmental issues (electric vehicles) and to developing new products.

Chart B2-2: Intangible Asset Investment

1. Software Investment **2. R&D Investment**



Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
Notes: 1. Figures for software investment are based on the *Tankan* (all enterprises). Figures for fiscal 2024 are from the March 2025 survey.
2. Figures for R&D investment are for intramural expenditure on R&D and taken from the *Survey of Research and Development* (all enterprises). Figures for fiscal 2024 are calculated using the year-on-year rate of change in R&D investment in the March 2025 *Tankan*.
3. Broken lines denote the linear trends from fiscal 2005 to 2024.

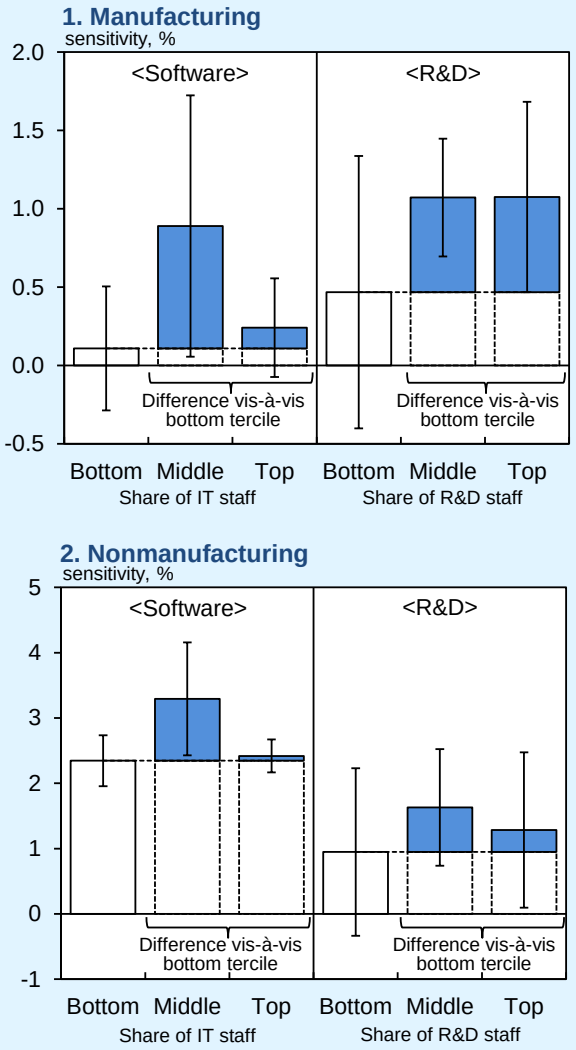
To examine whether an increase in intangible asset investment has led to a rise in labor productivity, an empirical analysis was carried out using microdata from the *Basic Survey of Japanese Business Structure and Activities*, which includes the number of IT staff and R&D staff at the firm level. The estimation results suggest that, (1) an increase in R&D investment is effective in further pushing up labor productivity, especially in manufacturing, and the higher the share of specialized personnel, the more prominent the effect; and (2) an increase in software investment is effective in raising firms' productivity, mainly in nonmanufacturing (Chart B2-3).

It is also argued that not only an increase in intangible asset investment but also firms' active use of digital services likely leads to improved labor productivity and profitability. Balance of payments figures show that the amount of payments made by Japanese firms for cloud-related services has been clearly on the

rise in recent years (Chart B2-4[1]). Cloud-related services are widely used by firms not only for office work, such as email, but also for production and sales activities and for R&D activities, suggesting that cloud services are now possibly a factor pushing up productivity by, for example, increasing the efficiency of corporate activities overall.

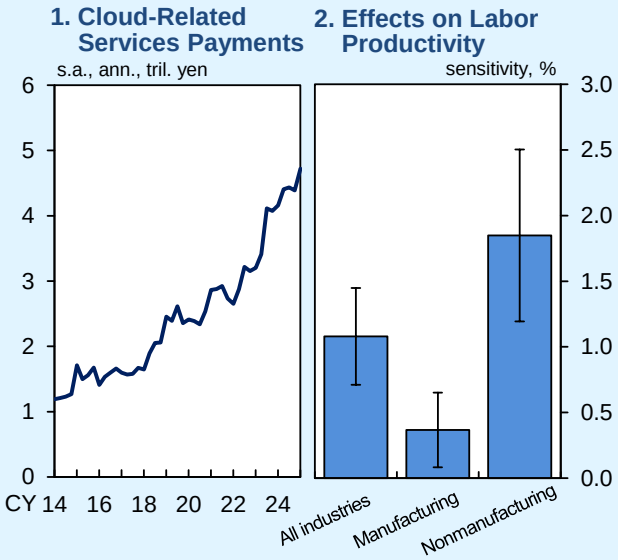
To confirm this point, another empirical analysis was conducted using microdata from the *Basic Survey of Japanese Business Structure and Activities*, this time on the effects of the use of cloud services on firm-level productivity. The estimation results show that firms with greater information processing and communication expenses, which include firms' cloud service-related payments, have raised their labor productivity significantly (Chart B2-4[2]). This boost to labor productivity is particularly noticeable in labor-intensive nonmanufacturing, suggesting that the use of cloud services may be mitigating the impact of labor shortages to some extent.

Chart B2-3: Effects of Software and R&D Investment on Labor Productivity



Source: Ministry of Economy, Trade and Industry.
Note: Figures are the estimated effects of a 1 percent increase in intangible assets on labor productivity per employee using microdata from the *Basic Survey of Japanese Business Structure and Activities*. In the estimation, firms in each fiscal year, industry, and firm-size category are classified into the top, middle, and bottom terciles in terms of the share of IT or R&D staff in all employees. IT staff consist of employees in firms' information processing department, etc., while R&D staff consist of employees in firms' R&D department, etc. In the estimation for software, the explanatory variable is the software capital stock per employee, while in the estimation for R&D it is the R&D capital stock per R&D staff. Capital intensity (excluding software and R&D investment, respectively), information processing and communication expenses, firm fixed effects, and time fixed effects are controlled for. The estimation period is from fiscal 2013 to 2022. The bands indicate ±1.5 standard error (for the top and middle terciles, the bands indicate ±1.5 standard error for the estimated differences vis-à-vis the bottom tercile).

Chart B2-4: Cloud Services Usage



Sources: Ministry of Finance and Bank of Japan; Ministry of Economy, Trade and Industry.
Notes: 1. Figures in the left-hand chart are those for "telecommunications, computer, and information services" payments based on the *Balance of Payments*, seasonally adjusted based on staff calculations. The figure for 2025/Q1 is the January-February average.
2. Figures in the right-hand chart represent the estimated effects of a 1 percent increase in information processing and communication expenses per employee on labor productivity per employee using microdata from the *Basic Survey of Japanese Business Structure and Activities*. Capital intensity, firm fixed effects, and time fixed effects are controlled for. "Information and communications" and "electricity, gas, heat supply, and water" are excluded from the estimation. The estimation period is from fiscal 2013 to 2022. The bands indicate the 95 percent confidence intervals.

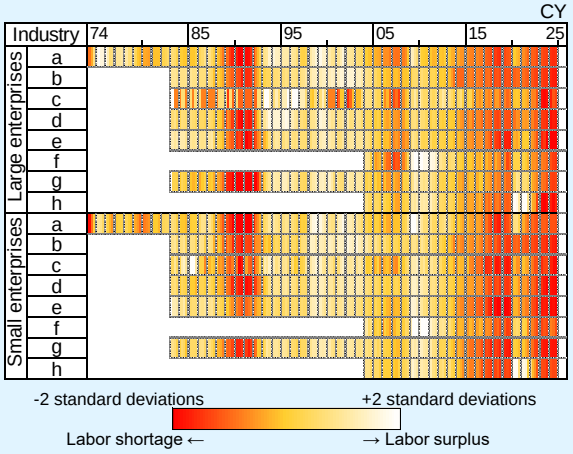
(Box 3) Labor Market Conditions and Labor Mobility across Firms

This box examines developments in labor mobility across firms amid a strengthening trend toward tightening in labor market conditions.

First, the heat map of the employment conditions DI in the *Tankan* shows that labor shortages have continued to be severe across a wide range of industries and among both small and large firms (Chart B3-1). [28] Examining labor market conditions for full-time and part-time employees separately shows that labor market conditions for full-time employees -- who are assumed to be employed for a longer period -- have recently become tighter than those for part-time employees, suggesting strong demand among firms that expect labor shortages to be prolonged (Charts B3-2 and B3-3).[29]

In the previous Outlook Report, an unemployment-vacancy (U-V) analysis carried out using the job vacancy rate (= number of unfilled vacancies / number of regular employees) in the *Survey on Labour Economy Trend* was used to distinguish structural and cyclical changes in the

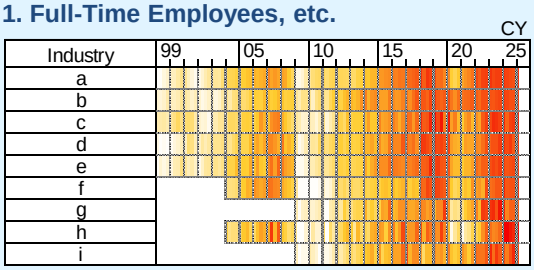
Chart B3-1: Heat Map for Labor Market Conditions, *Tankan*



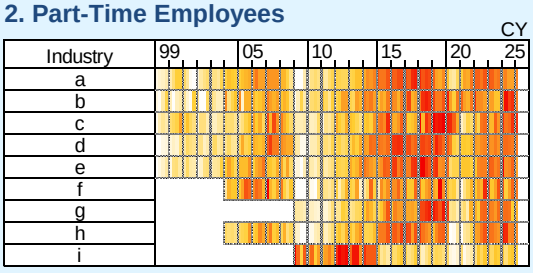
Source: Bank of Japan.
Notes: 1. In this heat map, figures for the employment conditions DI in the *Tankan* are normalized using the average and standard deviation for each industry and enterprise size over the period overall. Large enterprises are enterprises with a capitalization of 1 billion yen or more, while small enterprises are enterprises with a capitalization of 20 million yen or more but less than 100 million yen.
2. Figures for (g) services from March 2010 onward are calculated as the weighted averages of figures for "services for businesses" and "services for individuals." The number of reporting enterprises is used as weights.
3. The industries are as follows:
(a) manufacturing; (b) construction; (c) real estate; (d) wholesaling and retailing; (e) transport and postal activities; (f) information and communications; (g) services; (h) accommodations, eating and drinking services.

Chart B3-2: Heat Map for Labor Market Conditions, by Industry

1. Full-Time Employees, etc.



2. Part-Time Employees



Source: Ministry of Health, Labour and Welfare.
Notes: 1. In these heat maps, figures for the DI for enterprises' employment conditions in the *Survey on Labour Economy Trend* are normalized using the average and standard deviation for each type of employment and industry over the period overall. In the upper chart, figures before 2008 are based on those for regular employees.
2. Regarding the color coding, refer to the legend in Chart B3-1.
3. The industries are as follows:
(a) manufacturing; (b) construction; (c) real estate, goods rental and leasing; (d) wholesaling and retailing; (e) transport and postal activities; (f) information and communications; (g) living-related and personal services; (h) accommodations, eating and drinking services; (i) medical, health care, and welfare.

[28] For the compilation method of the heat map that shows the tightness of labor market conditions, see Box 2 of the October 2024 Outlook Report.

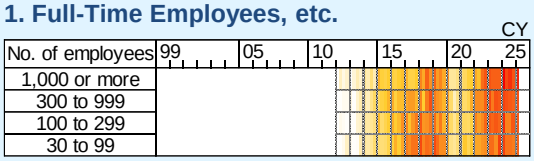
[29] The heat map of labor market conditions by type of employment is constructed using the Ministry of Health, Labour and Welfare's *Survey on Labour Economy Trend*, from which it is possible to obtain DIs for the excess/shortage of employees separately for full-time and part-time employees.

unemployment rate (Chart B3-4[1]). [30] A calculation of the unemployment gap (the gap between the actual unemployment rate and the structural unemployment rate, estimated using the same method as the above) shows that the level of tightness in labor market conditions has been further increasing recently and has been higher than during the bubble period in the second half of the 1980s (Chart B3-4[2]). This is partly due to, (1) a declining trend in the actual unemployment rate reflecting an increase in labor demand; and, (2) a rise in the structural unemployment rate led by voluntary separation being pushed up by the growing market for job changers.

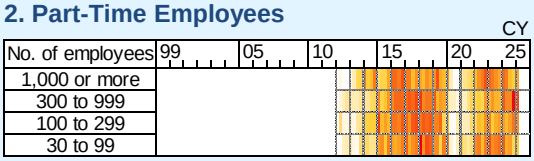
Indeed, the share of mid-career hiring has been on an increasing trend. This indicates a growing market for job changers and increased labor mobility across firms in recent years. Moreover, the share of workers whose wages increased due to job changes has reached a record high recently, suggesting that firms are actively raising wages of those in mid-career recruitment to secure personnel. The share of job changes involving wage increases rose to 35 percent in 2024, from 25 percent at the beginning of the 2010s.[31]

Chart B3-3: Heat Map for Labor Market Conditions, by Enterprise Size

1. Full-Time Employees, etc.



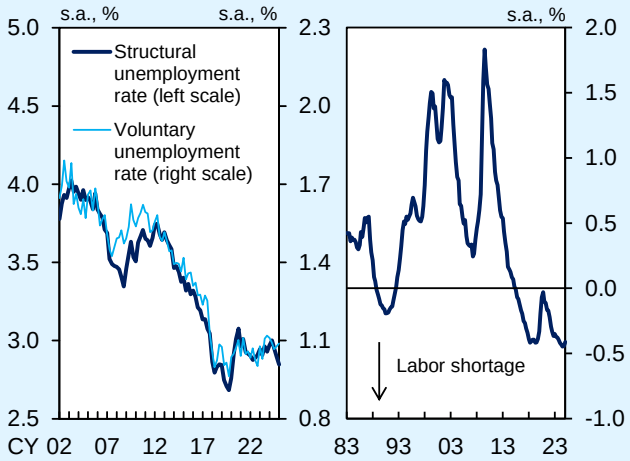
2. Part-Time Employees



Source: Ministry of Health, Labour and Welfare.
Notes: 1. In these heat maps, figures for the DI for enterprises' employment conditions in the *Survey on Labour Economy Trend* are normalized using the average and standard deviation for each type of employment and enterprise size over the period overall. The size classification is based on enterprises' number of regular employees.
2. Regarding the color coding, refer to the legend in Chart B3-1.

Chart B3-4: Unemployment Gap

1. Structural Unemployment Rate **2. Unemployment Gap**



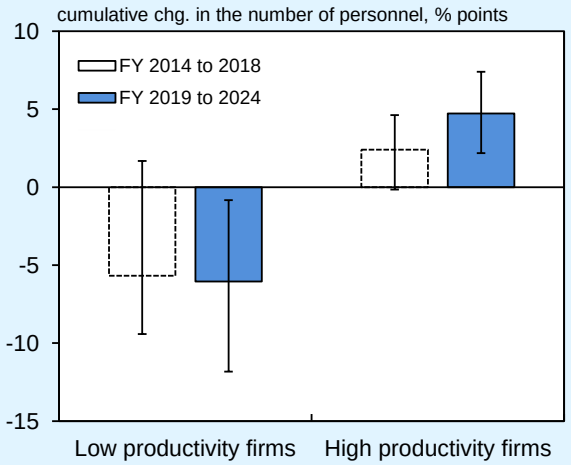
Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.
Notes: 1. Figures for the structural unemployment rate from 2020/Q1 onward are estimated using the job vacancy rate from the *Survey on Labour Economy Trend*. Voluntary unemployment rate = Number of unemployed persons who voluntarily quit their job / Labor force
2. Unemployment gap = Unemployment rate - Structural unemployment rate
3. Figures for 2025/Q1 are January-February averages.

[30] In the U-V analysis, labor supply and demand are considered to be in equilibrium as a whole when the job vacancy rate equals the unemployment rate, and the unemployment rate at such time is regarded as the structural unemployment rate. In the analysis below, the structural unemployment rate is estimated using a statistical method in which the intercept of the U-V curve changes depending on the time, on the assumption that the slope of the U-V curve is stable in the long term.

[31] "Tenshoku ji no chingin hendō jōkyō" [Changes in wages upon job changes] surveyed by Recruit, Co., Ltd.

A look at labor mobility across firms via the labor market for job changers from the firms' perspective shows that, in recent years, the number of employees at firms with high productivity has been increasing while that at firms with low productivity has been decreasing (Chart B3-5). This observation suggests the possibility that the difference in firms' productivity levels creates the gap in their wages, leading eventually to the difference in the number of new employees that firms can hire. It is confirmed in another analysis that, from the workers' point of view, if the annual income from their current job and expected real wages are low, these workers are more likely to choose to change jobs.[32]

Chart B3-5: Labor Mobility across Firms



Source: Ministry of Finance.
Note: The chart uses microdata from the *Financial Statements Statistics of Corporations by Industry, Quarterly*, for firms that responded to the survey for the statistics for eight consecutive quarters. High/low productivity firms are defined as those in the top/bottom tercile within each period and industry. Figures are medians of deviations in the rate of change in the number of personnel from that of the entire sample. The bands indicate 95 percent confidence intervals calculated using the bootstrap method. The broken lines indicate that the results are not statistically significant.

As described above, increasing dispersion in wage levels seems to be encouraging more labor mobility across firms via the labor market for job changers as the overall labor market tightens further.

[32] An estimation of determinants of workers' willingness to change jobs -- using microdata from the *Japanese Panel Study of Employment Dynamics* released by the Recruit Works Institute -- shows that workers' willingness to change jobs increases when their annual income from the current job is lower than the industry average, and that when inflation expectations are high, expected real wages are low, and the probability of willingness to change jobs is pushed up statistically significantly.

(Box 4) Recent Developments in Wage Increases and Price-Setting Behavior

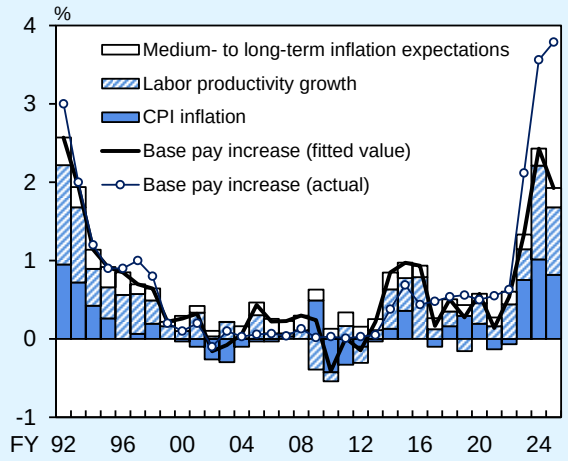
This box uses various measures to examine recent increases in wages of full-time employees, and then analyzes the relationship between firms' wage- and price-setting behavior using firm-level data.

Based on the Japanese Trade Union Confederation's (Rengo) fourth aggregation, as of April 17, the rate of increase in base pay for fiscal 2025 is 3.79 percent, slightly higher than the figure of 3.57 percent at around the same time in 2024 and the final result of 3.56 percent for fiscal 2024. A regression using data from fiscal 1992 through fiscal 2022 -- with the rate of increase in base pay as the dependent variable and the inflation rate, labor productivity, and medium- to long-term inflation expectations as explanatory variables -- shows that actual values of increases in base pay are clearly above the fitted values for fiscal 2023 onward (Chart B4-1[1]). This indicates a structural change in the determinants of base pay increases in recent years from the deflationary period. One possible indication of a structural change is, as pointed out in Box 3, the fact that, with a growing sense of labor shortages of full-time employees under the expansion of the market for job changers, tight labor market conditions have started to exert upward pressure on scheduled cash earnings of full-time employees, which used to be less affected by labor market conditions (Chart B4-1[2]).

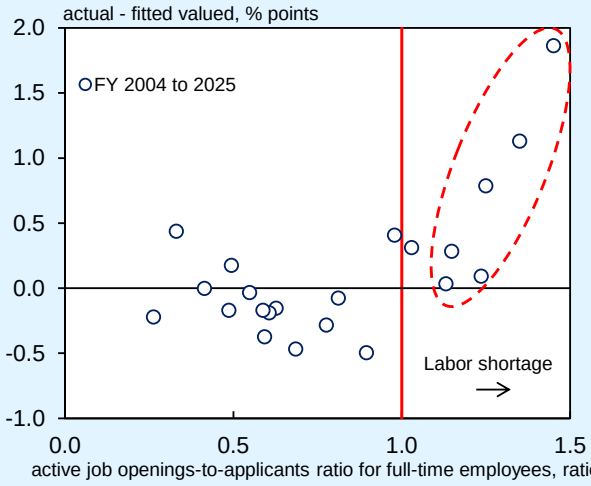
Upward pressure on wages, which has been intensifying among full-time employees, is most

Chart B4-1: Base Pay Increases and Labor Shortages

1. Base Pay Regression



2. Residuals of the Base Pay Regression



Sources: Central Labour Relations Commission; Japanese Trade Union Confederation (Rengo); Ministry of Internal Affairs and Communications; Cabinet Office; Ministry of Health, Labour and Welfare; Nowcast Inc., etc.

Notes: 1. Figures for CPI inflation are for all items less fresh food, excluding the effects of the consumption tax hikes, etc. Figures for actual base pay increases from fiscal 1992 to 2013 are those published by the Central Labour Relations Commission, while those from fiscal 2014 onward are figures released by Rengo (the figure for fiscal 2025 is from Rengo's fourth aggregation).

2. The base pay regression for the estimation of base pay increases is specified as shown below. The estimation period is from fiscal 1992 to 2022. *** and ** indicate that coefficient estimates are statistically significant at the 1 percent and 5 percent levels, respectively.

Base pay increase = 0.33*** × CPI inflation (t-1)
+ 0.24*** × Nominal labor productivity growth (t-1)
+ 0.13** × Medium- to long-term inflation expectations (t-1)

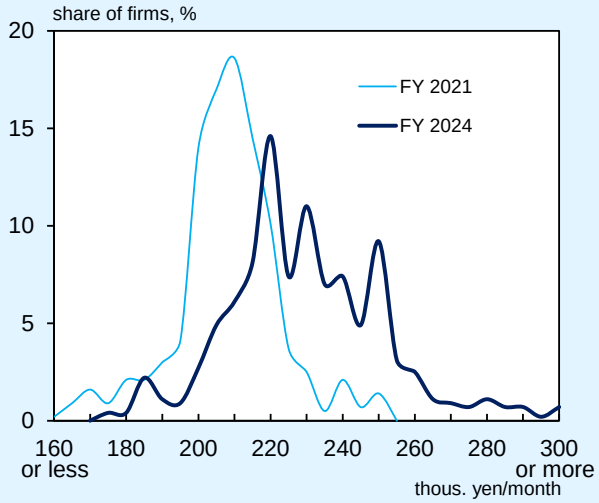
3. In the lower chart, figures for the active job openings-to-applicants ratio for full-time employees from fiscal 2020 onward are estimated using the Job Postings Index for full-time jobs from *HRog Wage Now*. The figure for fiscal 2025 is an estimate based on recent trends.

evident in the labor market for new graduates. Indeed, new graduates' starting salaries in fiscal 2025 are likely to be at a much higher level than before, as was the case in fiscal 2024. The firm-level distribution of starting salaries shows that, while the dispersion was relatively narrow around fiscal 2021, with a concentration on its peak at around 210,000 yen. In the past few years, however, the distribution has shifted clearly to the right, and the share of firms in the upper tail has increased (Chart B4-2). The hike in starting salaries is considered to also lead to a hike in wages of other younger employees whose wages are close to those of new graduates on the wage curve. If firms further revise their seniority-based wage curves upward, based on the hike in starting salaries, overall wage levels may also rise.

Moves to raise wages of full-time employees have been spreading from large firms with labor unions to small and medium-sized firms, with some time lag. Examining actual wage increases in fiscal 2024, (1) the rate of wage increases was higher in firms with labor unions; and (2) among firms with labor unions, the larger the firm, the higher the wage increases tended to be (Chart B4-3). The rate of increase in the base pay growth rate for fiscal 2025 (based on Rengo's fourth aggregation) for small and medium-sized firms (less than 300 employees) has been greater than large firms, suggesting that moves to raise wages of full-time employees have been steadily spreading to small and medium-sized firms.

The relationship of firms' active stance toward raising wages and their recent price-setting behavior is examined by an empirical analysis

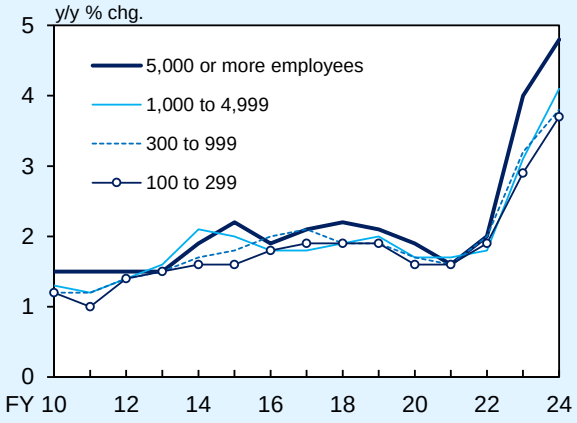
Chart B4-2: Distributions of Starting Salaries



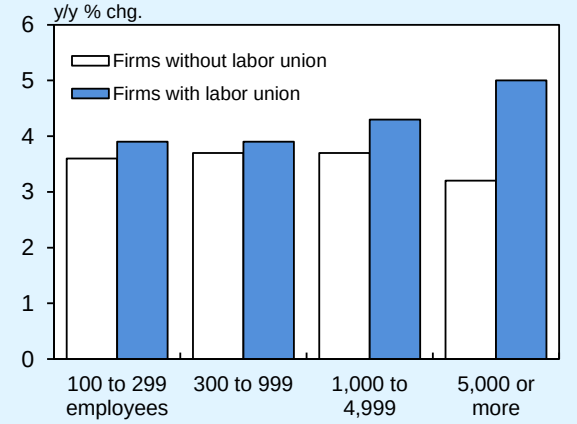
Source: The Institute of Labour Administration.
Note: The chart shows the distributions of starting salaries for new university graduates at listed firms and non-listed firms with a capitalization of 500 million yen or more or 500 employees or more.

Chart B4-3: Rate of Wage Increases

1. By Firm Size



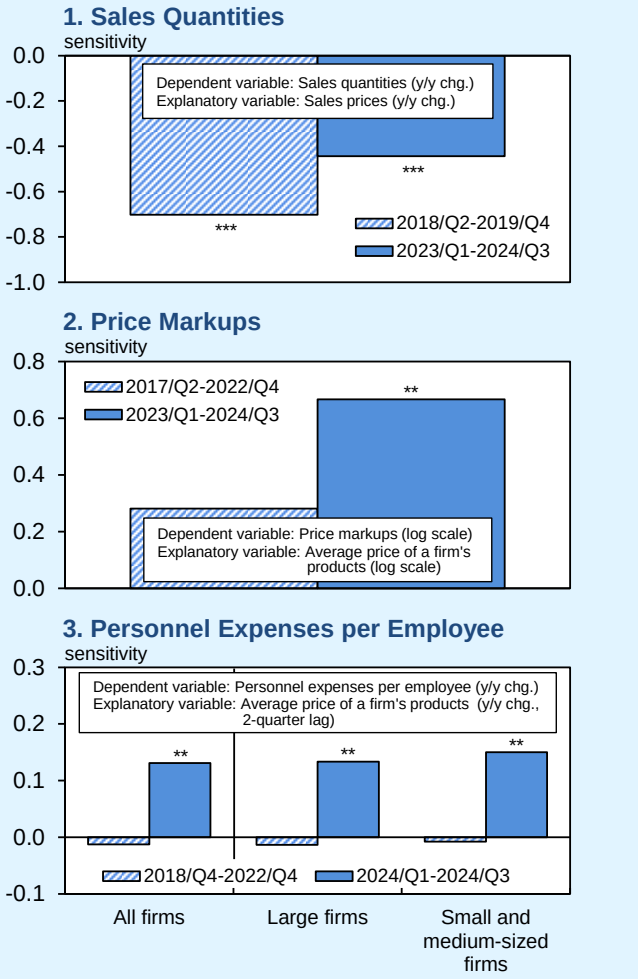
2. By Labor Union Status (FY 2024)



Source: Ministry of Health, Labour and Welfare.
Notes: 1. The rate of wage increases is the rate of revision in scheduled cash earnings per regular employee.
2. The firm size classification is based on firms' number of regular employees.

using firm-level data. Specifically, point-of-sale (POS) data was used to compile firm-level average price of products sold by individual firms, which was then matched with firm-level microdata from the *Financial Statements Statistics of Corporations by Industry, Quarterly*.[33] The analysis shows that the decline in sales quantities in response to a rise in the relative price of firms' products was smaller than before the COVID-19 pandemic (Chart B4-4[1]).[34] This suggests the possibility that there has been a decline in the past few years in consumers' price elasticity of demand (a value that shows the percentage decline in sales when the relative price of the firm's product is raised by 1 percent). Moreover, in the current inflationary phase, price markups of firms that have raised their sales prices tend to have increased,[35] suggesting that these firms' profit per unit sold (unit profit) may have also been rising (Chart B4-4[2]). In addition, labor costs per employee of firms that have raised their sales prices indicate that, recently, firms that have raised prices more have a higher rate of increase in wages (Chart B4-4[3]). These findings suggest that, at present, a mechanism is at work whereby firms that are able to raise their price markups are also increasing wage payments with some time lag, and this pattern may be spreading to small and medium-sized firms as well.

Chart B4-4: Effects of Raising Sales Prices



Sources: Merchandising-ON Co., Ltd., "RDS-POS (Retail Measurement Data Services)"; Ministry of Finance.

Notes: 1. Figures in the upper chart are estimated using point-of-sales (POS) data. In the estimation, item fixed effects and time fixed effects are controlled for.
2. Figures in the middle and lower charts are estimated using firm-level panel data compiled by matching the POS data (average price of a firm's products) with microdata of the *Financial Statements Statistics of Corporations by Industry, Quarterly* (price markups and personnel expenses per employee). In the estimation, firm fixed effects and time fixed effects are controlled for.
3. *** and ** denote statistical significance at the 1 percent and 5 percent levels, respectively.

[33] For the calculation of the average sales price of each firm, principal components obtained from various sales prices of the firm was used.

[34] Using a standard individual demand curve, the change in sales volumes due to a change in the relative price of firms' products was examined while controlling for the macroeconomic inflation environment and other factors using time-fixed effects.

[35] Price markups are calculated in this box as "sales / total cost of goods sold" following previous studies.