

JAPAN

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STUCK IN THE MIDDLE OF INFLATION AND TARIFFS

The Japanese economy has been showing some momentum for just over a year. However, this performance is likely to fade in the second half of the year, not least as a result of the tightening of US trade policy. The labour market remains tight, and inflation continues to exceed the 2% target. Caught between an economic situation that may signal a weakening and a sharp rise in long-term interest rates amid fiscal concerns, the Bank of Japan (BoJ) is exercising extreme caution by raising its policy rate very gradually.

GROWTH: SURPRISING MOMENTUM THAT COULD FADE

The Japanese economy has just completed a run of five consecutive quarters of positive growth (including +0.6% q/q in Q4 2024, +0.1% and +0.5% in Q1 and Q2 2025), which has not been seen since 2017. The strong performance in Q2 2025, driven by household consumption (+0.4% q/q), was surprising in view of high inflation. Business investment contributed 40% to GDP growth in H1, compared with a negative contribution from foreign trade, with imports rebounding (+5.3% y/y over the half-year).

However, the Japanese economy's performance could subsequently falter, hampered by higher US tariffs and, crucially, by a domestic environment that could become stagflationary. Indeed, the Japanese economy seems to be operating at full capacity: according to the Cabinet Office, the output gap narrowed at the end of 2024 before turning slightly positive in 2025 (+0.1pp in Q2), against a backdrop of a tight labour market and expansionary fiscal policy. The turbulent political environment could also weigh on the economy (see below). However, the strength of the PMI indices (the composite index reached 52.0 in August, after four consecutive months of improvement) suggests that the slowdown may still be some way off and that growth could once again surprise on the upside in Q3 (compared with our forecast of 0% q/q).

A ONE-SIDED TRADE AGREEMENT WITH THE UNITED STATES

US policy poses a downside risk to Japanese growth. The US represents the largest export market for an economy whose goods exports accounted for more than 15% of GDP in 2024. In the first half of the year, the trade balance narrowed due to a rise in imports in Q1. On 22 July 2025, the United States and Japan reached a bilateral trade agreement, which was formalised on 4 September. Additional tariffs on Japanese products entering the United States are set at 15%, compared with a 'reciprocal' tariff of 25% announced on Liberation Day and another of 10% applied since 9 April. Importantly, this tariff will also apply to the automotive sector (as in the agreement with the EU), which accounts for nearly one-third of Japanese exports to the United States and for which the standard sectoral tariff is 25%. At the same time, Japan has committed to investing USD 550 billion in the US economy by 2029, as well as increasing the openness of its domestic market to US players, particularly those in the rice sector.

Overall, according to our estimates, the average tariff applied to Japanese exports is set to reduce to 11.5% (compared with 15% between April and the agreement of 22 July). Although this tariff remains well above the average level observed in 2024 (1.5%) and the agreement is lopsided, its conclusion reduces uncertainty. However, the full effect is yet to be felt. The context is also inflationary, with production costs leaving Japanese companies little scope to reduce their export prices. The export price index has been falling year-on-year since April 2025. This movement is much more pronounced in yen (JPY) than in foreign exchange contracts.

GROWTH AND INFLATION (YEARLY AVERAGE)

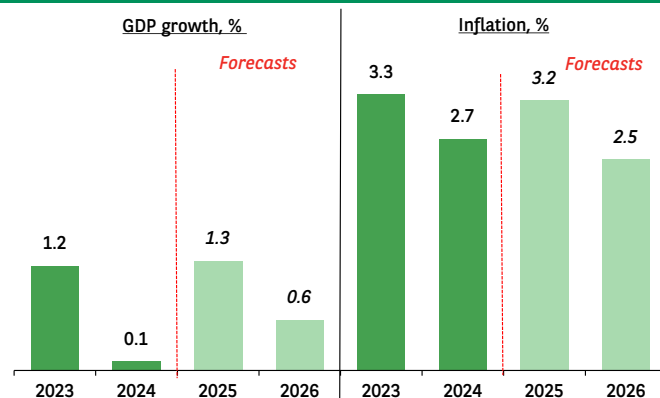


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

INFLATION PERSISTENTLY ABOVE TARGET

Inflation is expected to remain above the 2% target until the end of 2026, even if it has slowed down after reaching a 34-year high in Q1 2025 (+3.8% y/y). It remains driven upwards by the food component (+7.2% y/y on average since the start of the year, accounting for 58% of the year-on-year change in the CPI in 2025 to date). This is attributable to the major issue of rice prices (+90.7% y/y), which is set to continue according to the Bank of Japan (BoJ). Core inflation is also well above target (+3.2% y/y on average since the start of the year), with services inflation being more moderate (+1.5% y/y in June, +2.1% y/y excluding imputed rents, up very slightly since the start of the year). As for market inflation expectations, as measured by the 10-year breakeven inflation rate, they regained momentum from May 2025 onwards, after losing 30 basis points in April following Liberation Day in the United States. In August 2025, they stood at +1.5% (the historical record is 1.6%). This anticipated inflation closer to the target is a favourable sign, especially as the BoJ seeks to ensure that the country does not return to the deflationary spiral of the past once the temporary factors driving inflation have dissipated.

DESPITE A STRONG LABOUR MARKET, REAL WAGES ARE FALLING

The rise in contractual scheduled earnings, an underlying measure of wage growth, reached 2.5% y/y in July 2025, the highest since December 2024. More broadly, nominal income growth has been gradually picking up momentum over the course of the year, after dipping slightly at the end of Q1 2025. This strength is expected to continue, driven by a tight labour market, as illustrated by an unemployment rate (+2.3%) at its



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lowest since the end of 2019. In addition, the final results of the Shunto (+5.25%, Chart 2), the annual wage negotiations conducted by the Rengo trade union confederation, mark an improvement on 2024 (+5.1%) and a record high since 1991. However, persistent inflation is taking its toll on real wages. These have only been positive once in 2025 (+0.5% y/y in July), which is likely to weigh on Japanese household consumption.

THE BOJ IS EXPECTED TO RESUME MONETARY TIGHTENING AFTER A LONG PAUSE

The Bank of Japan has put rate hikes on hold for the time being. The uncollateralised overnight call rate (key interest rate) has been kept stable at +0.5% since the January 2025 hike (+25 bps). The gradual and cautious nature of monetary normalisation, linked to fragile domestic demand, has been amplified by uncertainty surrounding trade policy, the pause is continuing despite inflation remaining above target.

With trade uncertainties having eased, a rate hike is expected in December (+25 bps) in view of the inflation outlook and the central bank's communication. We then expect three further hikes (+25 bps) in 2026, one per quarter between Q2 and Q4. The BoJ's key rate would then reach 1.5%, which would correspond to a moderately accommodative monetary policy with inflation still above its target. These developments would result in an appreciation of the JPY against the USD (to 145 at the end of 2025 and 141 at the end of 2026), adding further pressure on Japanese companies.

TOWARDS HIGHER DEFICITS

Japan is seeking a new Prime Minister less than a year after the appointment of S. Ishiba (1 October 2024), whose resignation was announced on 7 September 2025. This departure follows two major electoral setbacks: the early general elections in October 2024 (loss of absolute majority for the LDP/Komeito coalition in the lower house) and the upper house elections (decline of the LDP) in July 2025. Ishiba's departure adds to the instability, in a context of a minority assembly and the rise of populist parties. Ishiba's successor as LDP president will be appointed during the internal election on 4 October and will, in all likelihood, become Japan's new PM.

Japan's primary deficit is projected to increase slightly to -2.4% of GDP in 2025 (+0.3pp) on the back of expansionary fiscal policy, before stabilising at this level in 2026, according to the IMF. The increase in interest payments will lead to a larger overall deficit (2.9% in 2025 and 3.1% in 2026, compared with 2.5% in 2024). At the same time, public debt is on a downward trajectory (234.9% in 2025 compared with 236.7% in 2024), due to inflation and stronger nominal GDP growth.

Furthermore, the current configuration of the Diet may lead the future PM to lean towards more fiscal stimulus. This, combined with the generally unstable situation, may add to the current pressure on bonds (Chart 3). This pressure partly reflects global fiscal concerns, but also concerns specific to Japan, due to the high level of public debt and expectations of rate hikes by the BoJ.

JAPAN: RECORD INCREMENTS IN SPRING WAGE NEGOTIATIONS (%)

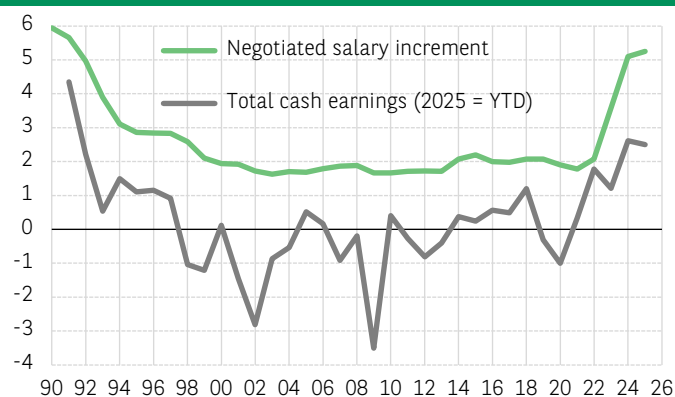


CHART 2

SOURCE: MACROBOND, BNP PARIBAS

JAPAN: PRESSURE ON JGB'S LONG-TERM YIELDS (%)

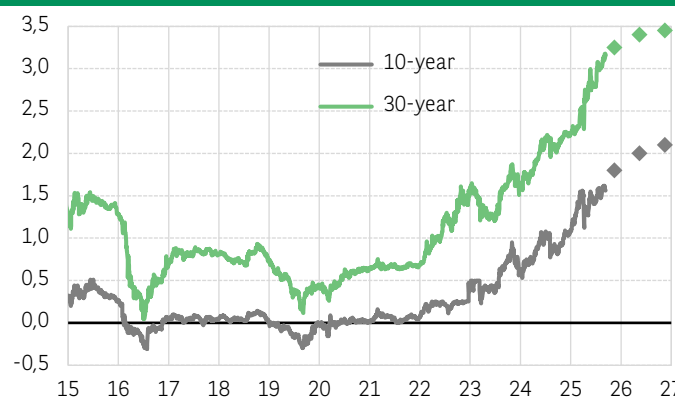


CHART 3

SOURCE: MACROBOND, BNP PARIBAS FORECASTS

Our central scenario anticipates a continued rise in bond yields, particularly long-term yields, with 10-year and 30-year rates reaching 2.0% and 3.4% respectively in mid-2026 (compared with 1.56% and 3.17% at present), before stabilising at this level over the horizon of our projections (Q4 2026).

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