

# Navigating Tariffs and Inflation: Japan's Economy Remains Resilient

14 August 2025

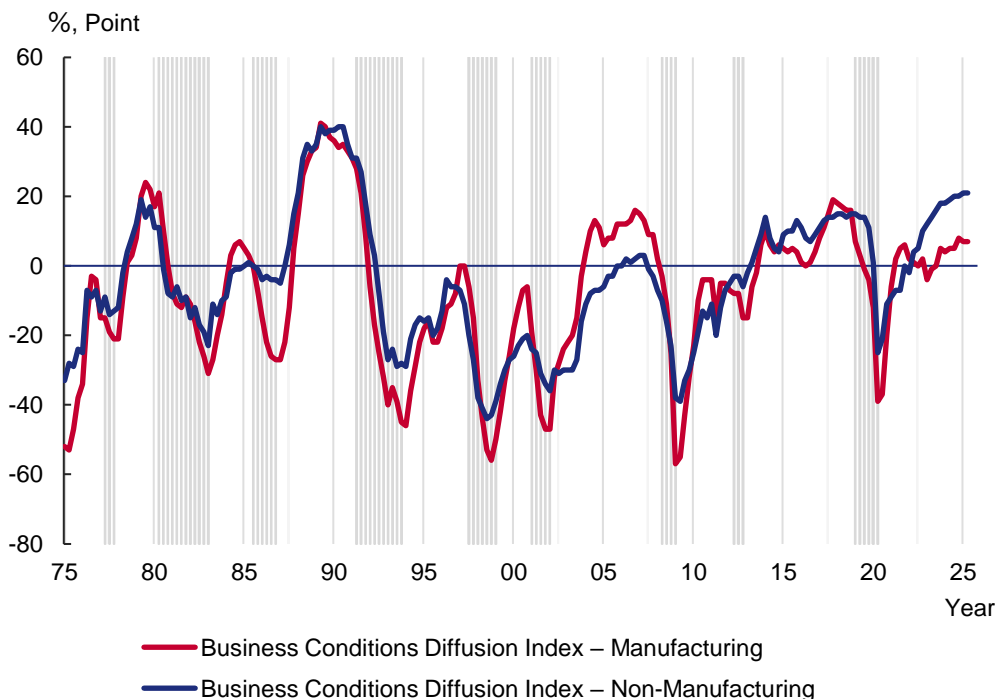
## Corporate Sentiment Remains Firm

According to the Bank of Japan's (BOJ) June Tankan survey, the Diffusion Index (DI) for business conditions showed a generally resilient trend. Despite the tariffs imposed by the United States, the manufacturing sector remained solid, while the non-manufacturing sector reached its highest level since Japan's bubble era (Figure 1). Against this backdrop, two key developments in July were particularly important for assessing Japan's economic outlook: the ruling party's defeat in the Upper House election, resulting in a minority government in both chambers, and the agreement reached between Japan and the U.S. regarding tariff negotiations.



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**Figure 1: BOJ Tankan – Business Conditions Diffusion Index**



Source: INDB, Asset Management One Co., Ltd.

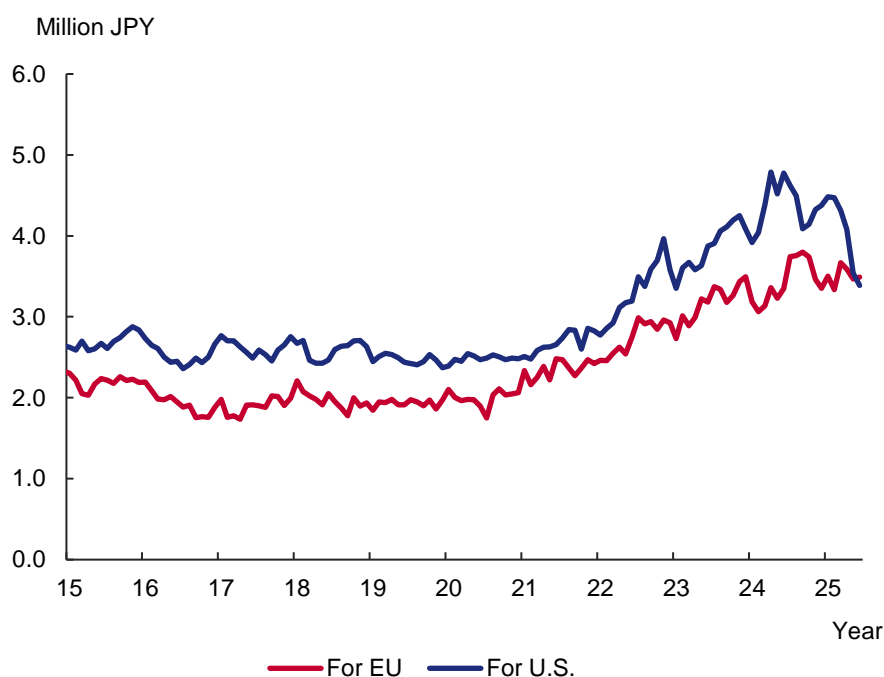
Note: 1. Quarterly data from March 1975 – June 2025

2. All company sizes included. Shaded areas indicate recession periods (as determined by the Japan Cabinet Office)

## Impact of Tariffs

Japan and the United States have agreed to reduce reciprocal tariffs from the initially planned 25% to 15%. Automotive tariffs will also be lowered to 15%, including existing rates. Nevertheless, U.S. imports from Japan will now be subject to a 15% tariff, raising concerns about the impact on production activities and corporate earnings, particularly in the manufacturing sector. To date, there has been no significant change in the volume of automobile exports to the U.S. However, export prices during May and June - when the 25% additional tariff was in effect - fell by approximately 20% compared to March (Figure 2). This suggests that companies responded to the tariff burden by lowering export prices, thereby worsening export profitability. Future pricing strategies will require close monitoring. Estimates suggest that the 15% tariff rate on exports to the U.S. could reduce Japan's economic growth rate by around 0.5 percentage points, due to a decline in export value. Looking ahead, attention should focus on: (1) the impact of tariff-related costs and global trade contraction on corporate performance, and (2) the effect of heightened uncertainty on capital investment.

**Figure 2: Export Prices of Automobiles from Japan**



Source: INDB, Asset Management One Co., Ltd.

Note: 1. Monthly data from January 2015 – June 2025

2. Calculated by dividing the export value of automobiles (in JPY) by the number of automobiles exported

## Political Landscape Remains Uncertain

Turning to domestic politics, the ruling coalition has lost its majority in both houses of the Diet, making parliamentary operations and policy management more challenging. To pass budgets and key legislation, cooperation with opposition parties has become increasingly important.

Looking ahead, Japan's political landscape is expected to remain fluid, with several possibilities on the horizon - including the selection of the next LDP president and prime minister, potential changes in the governing framework, and the prospect of a snap general election. These developments contribute to a sense of uncertainty, but also present opportunities for constructive dialogue.

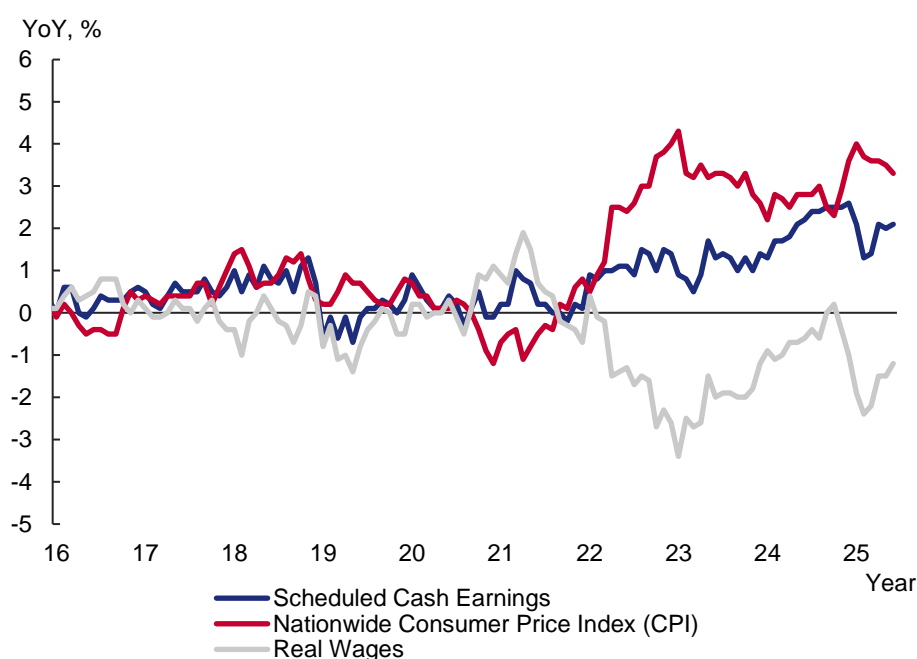
### Measures by Ruling and Opposition Parties to Address Inflation

Consumer prices remain elevated, while real wages continue to decline (Figure 3). Recent inflation has been significantly driven by rising food prices, particularly rice. Although inflation is expected to moderate and real wages are projected to turn positive from this autumn onward, rising costs of raw materials and labour, along with increasingly assertive corporate pricing strategies, suggest that prices may remain persistently high.

In the Upper House election, the ruling coalition (LDP and Komeito) proposed temporary, relatively restrained fiscal measures to combat inflation, including direct payments to households (approximately 3.5 trillion yen per year) and fuel subsidies (10 yen per litre). In contrast, major opposition parties advocated more extensive and permanent tax cuts, such as reductions or elimination of the consumption tax (5-30 trillion yen per year) and the abolition of the provisional gasoline tax rate (25.1 yen per litre).

Following the ruling coalition's loss of a majority in both houses, the ruling and opposition parties reached an agreement to abolish the provisional gasoline tax rate, contingent upon securing stable financial resources. Going forward, discussions surrounding the consumption tax rate will be closely watched. Prime Minister Ishiba has previously expressed a favourable stance toward reducing the consumption tax on food items, raising the possibility that such measures being considered.

Figure 3: Real Wages



Source: INDB, Asset Management One Co., Ltd.

Note: 1. Monthly data from January 2016 – June 2025

2. Real wages are calculated as the year-on-year change in scheduled cash earnings minus the year-on-year change in the nationwide Consumer Price Index (CPI)

## **Economic and Price Impacts**

When comparing cash handouts and consumption tax cuts, handouts are quicker to implement but tend to be saved rather than spent. Based on past experience, it is estimated that only about 30% of the distributed amount translates into increased consumption.

On the other hand, consumption tax cuts require legal amendments and system adjustments at retail stores, making implementation more time-consuming. Additionally, when the tax rate is later restored, it may trigger last-minute demand followed by a decline in consumption. If economic conditions deteriorate, the tax cut period may be extended, potentially leading to a prolonged period.

According to multiplier analysis by the Cabinet Office, consumption tax cuts have approximately twice the impact on consumption compared to cash handouts of the same amount.

In terms of the Consumer Price Index (CPI), reducing the consumption tax rate on food from 8% to zero would lower the CPI growth rate by approximately 1.5 percentage points. Eliminating the provisional gasoline tax rate would reduce it by about 0.2 percentage points.

## **Effective Policies to Support Economic Stability**

Measures aimed at easing the burden of essential goods such as food and gasoline are expected to improve consumer sentiment. As downward pressure intensifies on manufacturing industries - particularly exporters - supporting household disposable income will be crucial for sustaining the virtuous cycle between wages and prices.

However, the impact on tax revenue is substantial: abolishing the provisional gasoline tax rate would result in an annual revenue loss of approximately 1.5 trillion yen, while reducing the consumption tax on food to zero would lead to a loss of around 5 trillion yen per year.

Fiscal expansion risks driving up interest rates without boosting economic growth. To prevent this, it is essential to maintain fiscal discipline while implementing targeted, effective support measures. Although political instability is likely to persist for the time being, if the ruling and opposition parties can cooperate to implement effective policies, Japan will be well-positioned to navigate the challenges posed by tariffs and inflation and maintain a stable economic trajectory.

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