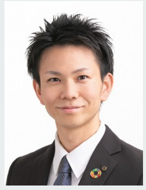
Daiwa's Economic View

Japanese economy/inflation under Trump tariffs: Status and outlook (1)

- Japan's economy remains upbeat, but tariff impact could emerge
- Balance of economic risks skews sharply to downside
- New Trump tariffs would depress Japan's real GDP by around 1.1ppt

FICC Research Dept.



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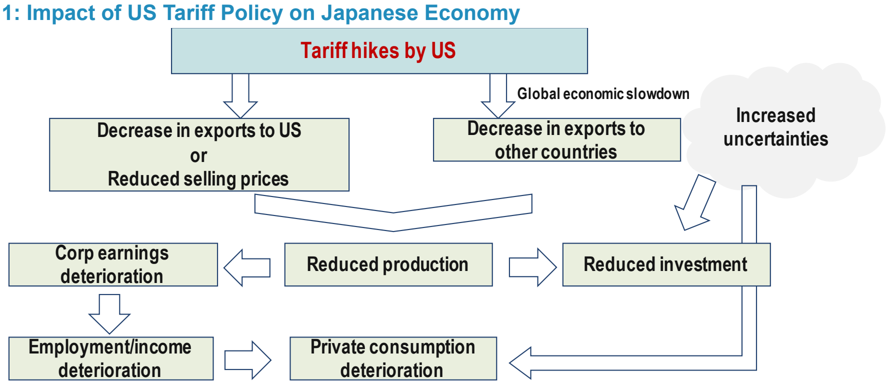
Exports/production remain firm, but tariff impact could emerge

Three months have passed since April, when Trump tariffs took effect in earnest. In a two-part report, we survey the current state of Japan's economy and inflation under Trump tariffs, and the future outlook. The first part of our report focuses on the economy.

Firstly, Trump tariffs have a variety of implications for the Japanese economy, via (1) direct effects such as an increase in export prices (including tariffs) that harms price competitiveness and reduces exports to the US, (2) the indirect effect of a decline in Japan's global exports caused by the slowing world economy, and (3) spending curbs caused by rising uncertainty (Chart 1). Direct effects would also include price cuts by exporters in an attempt to remain competitive on price and mitigate any decline in volume.

Chart 1: Impact of US Tariff Policy on Japanese Economy



- **Possibility of standstill for underlying price increases**, including impacts on spring wage negotiations in 2026

Source: Compiled by Daiwa.

On the export front, Japan's real exports to the US trended downward through May, but its exports to other countries and regions were broadly flat (Chart 2). Export volume to the US also looks solid considering the pullback that likely followed the frontloading of demand before tariffs took effect.

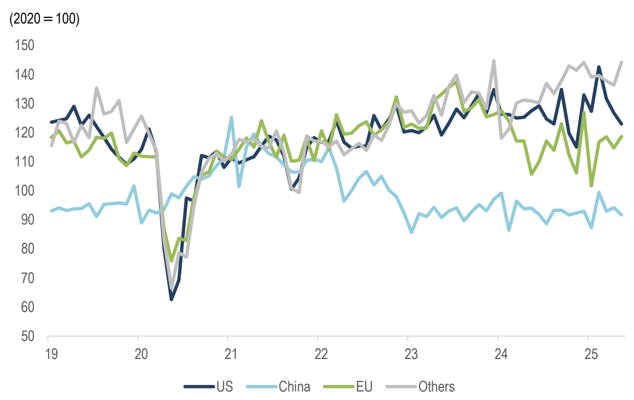
Meanwhile, the value of Japan's auto exports to the US fell a sharp 24.7% y/y in May. Breaking down the value of exports into price and volume factors confirms that falling prices have a major impact; this has led automakers to absorb the cost of tariffs to maintain their price competitiveness (Chart 3). While this corporate behavior will have a direct negative impact on Japanese corporate earnings, it will have little effect on export volume and production.

However, we would note that some major automakers opted to raise US prices in June and July. More widespread price hikes could further depress export volume. Thus far, higher costs resulting from tariffs have directly affected corporate earnings, but in future they could also affect export volume and production.

The value of steel exports to the US, which are subject to a 50% tariff, slumped by 29.0% y/y in April due to downward pressure from both price and volume factors, but the decline narrowed to -1.5% in May (Chart 4). We surmise that steelmakers have not responded with the kind of price cuts seen in autos, but despite this May export data showed little impact from tariff policy. This may be because US firms are bearing the cost of tariffs.

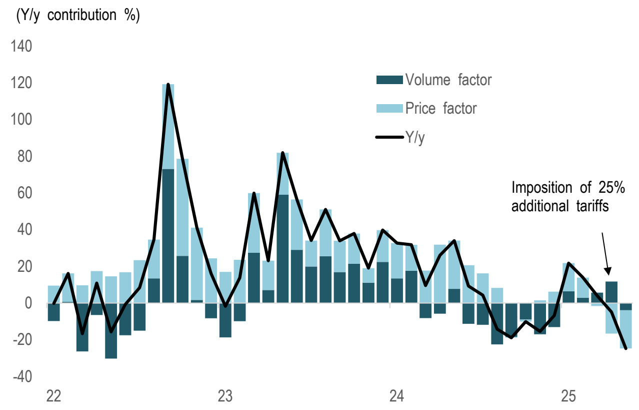
At this point, the move by Japanese and US firms to absorb the cost of tariffs (at the expense of lower profits) has minimized the impact on Japan's real economy (exports and production). However, we think there are limits to companies' ability to absorb these costs, and we will continue to watch for declines in export volume and a resulting impact on production. If companies continue to shoulder the cost of tariffs this will depress their earnings and in turn affect 2025 winter bonuses and 2026 wage hikes. Whichever of these forms it takes, we think an impact on the Japanese economy is likely.

Chart 2: Real Exports (seasonally adjusted)



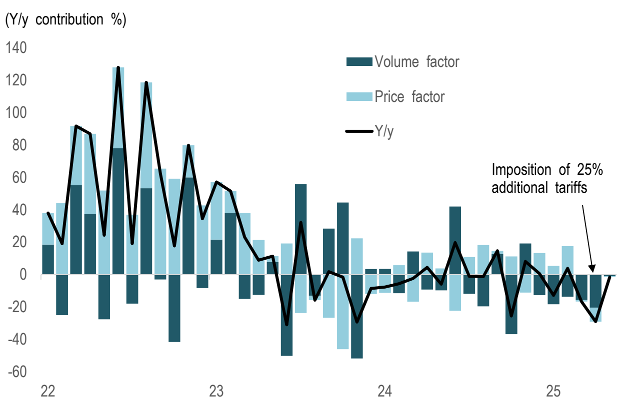
Source: BOJ; compiled by Daiwa.

Chart 3: Value of Auto Exports to US



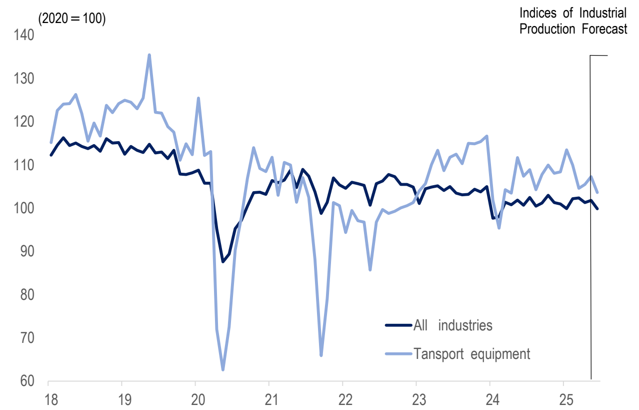
Source: MOF; compiled by Daiwa.

Chart 4: Value of Iron/Steel Exports to US



Source: MOF; compiled by Daiwa.

Chart 5: Industrial Production Index (all industries, transport equipment)



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

No need for pessimism on worsening trend assessment for business conditions index, but watch downside risk

Another focus of attention was the Cabinet Office's downward revision to its trend assessment for the indexes of business conditions released on 7 July to "worsening", for the first time since July 2020. This mechanical assessment is made when the three-month backward moving average for the coincident index has fallen for three consecutive months and the m/m change in the current month is negative.

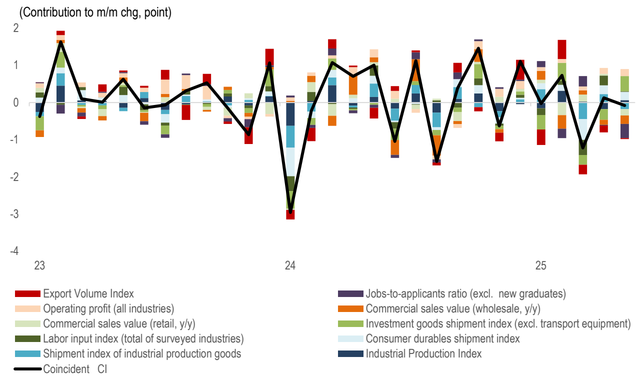
One reason for the "worsening" assessment was the sharp decline in the coincident index to 115.8 in March from 117.1 in February. This reflected a major contribution from declines in the indexes for producer goods and consumer durables shipments, reflecting a considerable impact from plant stoppages at some automakers. We think a downgrade to the trend assessment would have been avoidable had it not been for this one-time factor. We also see no need for undue pessimism given that the coincident index remains high.

However, we do not expect the assessment of the coincident index to be revised up from "worsening" to "halting to fall" given the potential impact on exports and production in the real economy, including from potential new tariff measures. The leading index also fell substantially, to 104.2 in April from 107.6 in March. While it also recovered somewhat in May, we see considerable near-term downside risk for the Japanese economy.

Chart 6: Coincident CI, Leading CI

Source: Cabinet Office; compiled by Daiwa.

Chart 7: Contribution to M/m Change in Coincident CI



Source: Cabinet Office; compiled by Daiwa.

New Trump tariffs would depress Japan's real GDP by around 1.1ppt

While the Japanese economy as a whole remains upbeat, we continue to see considerable downside risks. On 7 July, President Trump sent a letter to countries including Japan advising them of new tariff rates. Japan will be subject to a 25% "reciprocal" tariff from 1 August.

Our simulation suggests that this 25% tariff would depress Japan's real GDP by a cumulative 1.1ppt. We would expect FY25 real GDP growth to slow to around 0.1-0.2% as a result. (Charts 8, 9)

FY25 GDP growth includes a carryover effect. This refers to the phenomenon whereby high GDP at the end of a fiscal year results in a boost to nominal annualized growth even if GDP does not rise appreciably from this level in real terms. Given the carryover effect of around +0.3ppt in FY25, real growth of +0.1-0.2% would result in negative growth if the quarterly figures are added up.

Since April, the US has imposed a 10% "reciprocal" tariff plus a 25% sectoral tariff on individual products, with additional reciprocal tariffs on hold. If this rises to 25% across the board, we would expect a further decline in exports, production, capex, consumer spending, and corporate earnings. A 25% reciprocal tariff would likely push the (until now relatively resilient) Japanese economy past a tipping point.

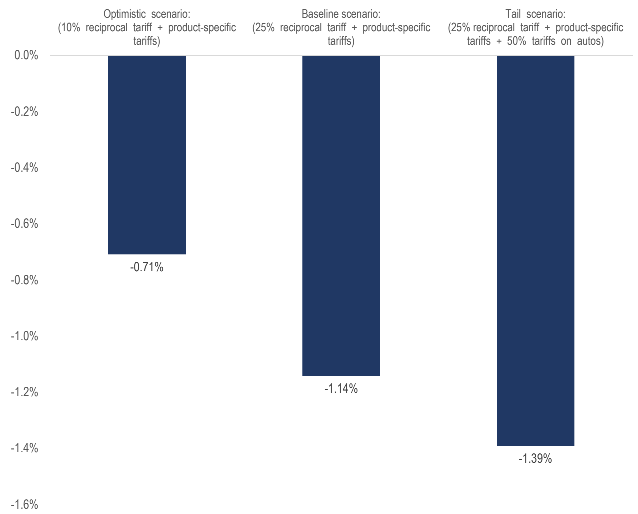
However, we would expect FY25 real GDP growth to remain close to zero even if the US imposes a 25% reciprocal tariff. At this point, we see a major shock from the impact of Trump tariffs as unlikely, a view echoed by BOJ policy board member Junko Koeda in a 8 July interview: while noting the substantial risk that the economy will slow in future, Ms. Koeda stated that a severe global recession is unlikely. From a monetary policy perspective, we do not think it is time to abandon rate hikes given the growing upward pressure on prices from structural labor shortages, and we expect the BOJ to maintain its policy of raising rates over the long term.

The key future focus for Japan in its negotiations with the US will be how to achieve a reduction in the 25% reciprocal tariff. We think the momentum of talks is likely to ramp up in earnest after the 20 July Upper House election, underscored by US Treasury Secretary Scott Bessent's comments that the election gives Japan "a lot of domestic constraints in terms of doing a deal." However, we think it will be extremely difficult to reach an agreement by 1 August given the lack of time for negotiations after the election and the growing likelihood that the ruling LDP-Komeito coalition will lose its majority.

We think these circumstances could lead Japan to ask the US for more time, and we also think the outcome of talks could fall somewhere between the optimistic scenario (10% reciprocal tariff + current product-specific tariffs) and baseline scenario (25% reciprocal tariff + current product-specific tariffs) in Charts 8 and 9.

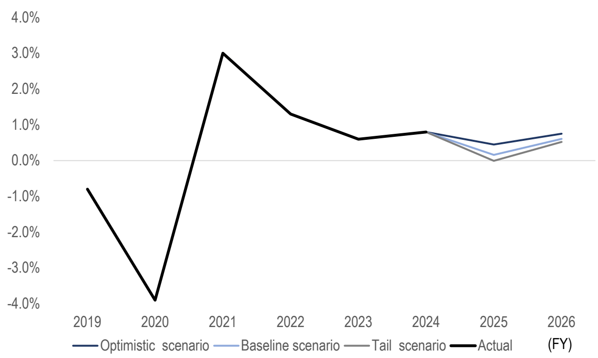
On 8 July, President Trump announced additional tariffs of 50% on copper and related products and 200% (with a grace period of at least a year) on sectors including pharmaceuticals. Copper and related products accounted for just 0.2% (Y38.98bn) of Japan's 2024 exports to the US, suggesting a minimal impact. On the other hand, Japan's pharmaceutical exports to the US were 1.9% of the total (Y411.47bn), and we estimate that a 200% additional tariff would depress real GDP by 0.05ppt.

Chart 8: Impact of Tariff Policy on Japan's Real GDP



Source: Compiled by Daiwa.
Note: Our simulation assumes the current product-specific tariffs of 50% on steel and aluminum and 25% on autos and auto parts, plus 25% on semiconductors and pharmaceuticals.

Chart 9: Forecasts for Real GDP Annual Growth Rate



Source: Compiled by Daiwa.
Note: Optimistic scenario: 10% reciprocal tariff + product-specific tariffs (scraps additional tariff), Baseline scenario: 25% reciprocal tariff + product-specific tariffs, and Tail scenario: 25% reciprocal tariff + product-specific tariffs + 50% tariffs on autos.

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