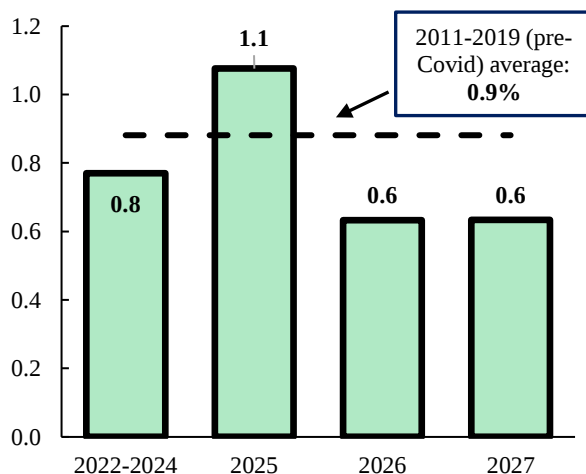


Can the new Japanese government overcome economic headwinds?

Japan is entering a new phase of economic policy as Prime Minister Sanae Takaichi, the country's first woman to hold the office, assumes the leadership of the country. PM Takaichi has vowed to revive Japan's economic growth through what she calls a "responsible proactive fiscal policy." This policy aims to strike a difficult balance between deploying spending in strategic sectors, while preserving fiscal sustainability and maintaining control over Japan's already-large public debt. Boosting growth is a formidable task for a country that faces significant structural challenges and an uncertain global outlook.

Japan's economic performance has been underwhelming in recent years. After the post-Covid pandemic rebound, annual real GDP growth fluctuated around 0.8% during 2022-2024. This year, the economy showed a modest recovery, supported by increasing real income that boosted consumption, fiscal stimulus, and a depreciated currency that backed exports. Growth in 2025 is expected to reach 1.1%, above the pre-Covid pandemic average of 0.9%. But tailwinds are again weakening, and adverse dynamics are gaining traction, worsening the outlook for the next couple of years.

Japanese Real GDP Growth
 (% , year over year)



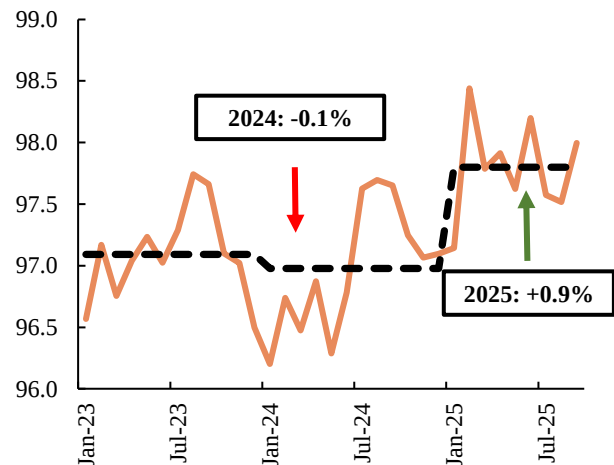
Source: Haver Analytics, IMF, Bloomberg, QNB Economics

In our view, given the significant headwinds weighing on the Japanese economy, it is unlikely that the new government will be able to revert a

deceleration of growth. In this article, we discuss the key factors that support our analysis.

First, stagnating consumption represents a substantial drag on economic growth. Consumption accounts for approximately 60% of the Japanese economy and is therefore a major factor in determining its performance. Despite an improvement this year relative to 2024, consumption has recently stagnated.

Consumption Activity Index
 (monthly, volume index 2015 = 100, and annual change %)



Source: Bank of Japan, QNB Economics

Behind weak consumption lies the erosion of the purchasing power of households due to high inflation rates. After several months of gains at the end of last year, workers' earnings adjusted for prices have contracted throughout this year, a trend that is expected to continue. Adding to the variables that weigh on consumption, the Bank of Japan continued its process of monetary policy normalization, bringing the benchmark policy rate to 0.5% from an ultra-low negative 0.1%, increasing the cost of credit for households, as well as reducing the room for fiscal policy due to the higher costs of debt. Given the importance of consumption in the economy, these negative trends are dragging on Japanese economic growth.

Second, external tailwinds for exports have weakened, implying less support for growth of the highly globally integrated Japanese economy. After a period of exceptional uncertainty regarding US

trade policy during the first semester this year, a trade agreement was finally reached in July between Japan and the US. The agreement established a baseline 15% tariff on nearly all Japanese imports entering the US. This implies a significant burden relative to the average tariff of 1.5% as of last year. Since the US is Japan's second-largest export market after China, accounting for around 20% of foreign sales per year, the new US tariffs represent a relevant barrier for foreign sales.

The expected slowdown in global trade, amid high trade-policy uncertainty and ongoing geopolitical fragmentation, adds to the pessimism for the Japanese economy, where exports represent 20% of GDP and are a key driver of industrial production. Given their importance for Japan, the weakening

prospects for exports represents a major headwind for its economic performance.

Amid the significant challenges affecting the economy, the new government will attempt drastic measures to boost growth. Within weeks of taking office, Takaichi unveiled a JPN 21.3 Tn (about USD 135 Bn) stimulus package plan, her first major economic initiative and a signal of policy direction. The plan combines new public-works outlays, household support measures, and targeted investment incentives to sustain demand.

In our view, however, it is unlikely that the stimulus package can generate a major shift in growth trends. Hence, Japanese economic growth is set to decelerate to 0.6% per year over 2026-2027, down from 1.1% expected for this year.

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