Provisional translation

Economic White Paper 2025

(Annual Report on the Japanese Economy and Public Finance)

- Overcoming Domestic and External Risks, Toward a “Growth-Oriented Economy” Driven by Wage Increases -

Summary

July 2025

Cabinet Office, Government of Japan

Contents

Chapter 1: Trends and Challenges in the Japanese Economy

Section 1: Economic Trends through Mid-2025
Section 2: Trends in Prices and Wages
Section 3: Current Situations and Challenges of Public Finance

Chapter 2: Tasks for Continuous Wage Increases and Recovering the Private Consumption

Section 1: Toward a Recovery in Private Consumption
Section 2: Toward Sustained Wage Increases
Section 3: Long-Term Changes and Challenges in the Labor Market

Chapter 3: The Changing Global Economy and Challenges for Japanese Firms

Section 1: Changes and Challenges in relationship between Japan and the Global Economy
Section 2: Changes and Challenges of Japanese Firms

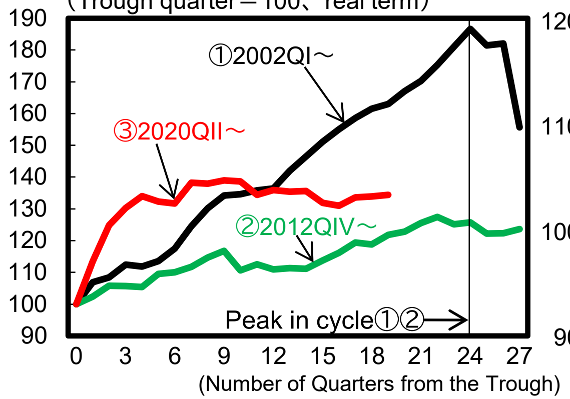
This material has been tentatively prepared to explain the Annual Report on the Japanese Economy and Public Finance. For quotations and other purposes, please refer to the text of the Annual Report on the Japanese Economy and Public Finance.

1-1: Economic Trends through Mid-2025 (1)

Figure 1: Comparison of past economic recovery phases and the current phase

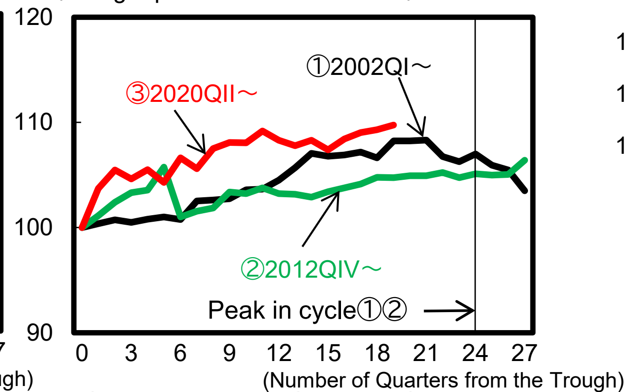
1. Goods Exports

(Trough quarter＝100、real term)



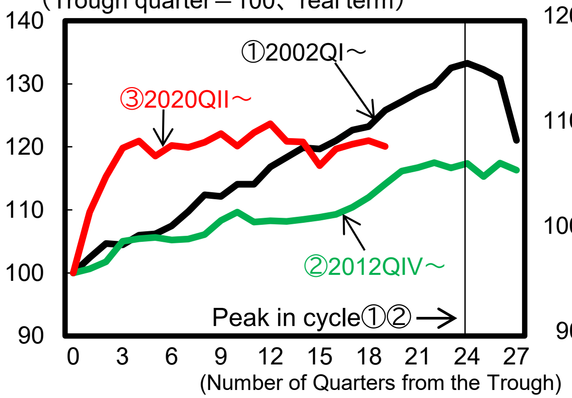
3. Domestic Private Final Demand (Private Consumption & Residential/Nonresidential Investment)

(Trough quarter＝100、real term)



2. GDP in Manufacturing Sector

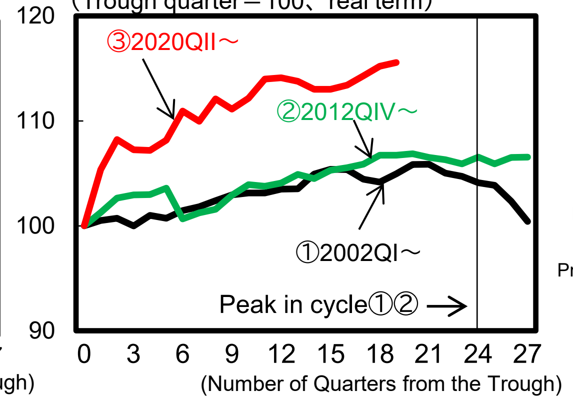
(Trough quarter＝100、real term)



4. GDP in Market Service Sector

(Excluding public sector, etc.)

(Trough quarter＝100、real term)

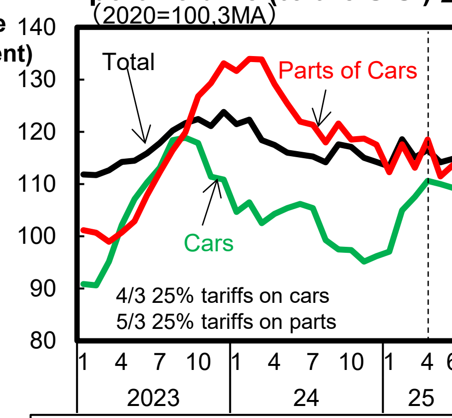


The current recovery phase is the third longest since the WWII. Unlike the previous two phases, which were led by goods exports and manufacturing sector, current recovery has been led by the service sector, partly because it starts after the pandemic of Covid-19, and domestic private final demand is continuing to grow. Attention should be given to the possible downside risks.

Figure 2: Exports to the United States(volume and price)

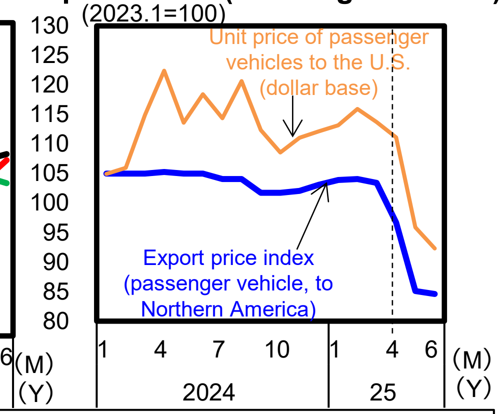
1. Export Volume (to the U.S.)

(2020=100,3MA)



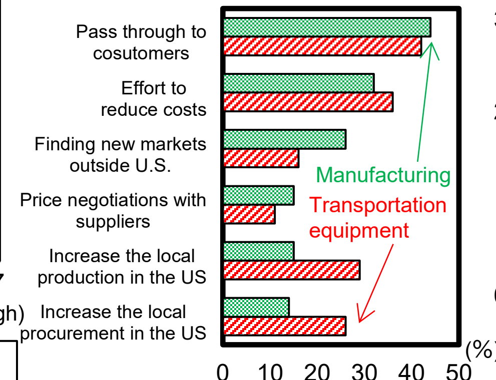
2. Export Prices (Passenger Vehicle)

(2023.1=100)



Right after the US tariff hike, export prices of cars (in US dollar) declined. As a result, effects on export volumes have been limited.

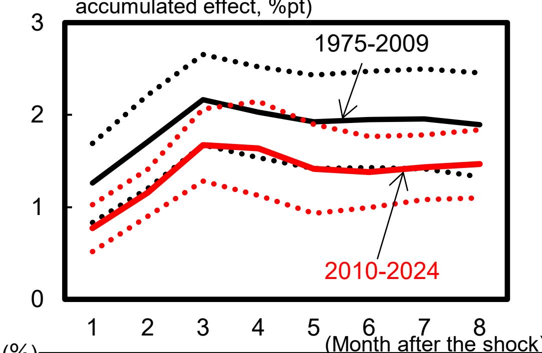
Figure 3: Firms' responses to the U.S. tariff measures



Top responses to the U.S. tariff measures by manufacturing firms include price pass-through and cost reduction.

Figure 4: Impact on Japan's real exports

(1% decline in global demand, accumulated effect, %pt)

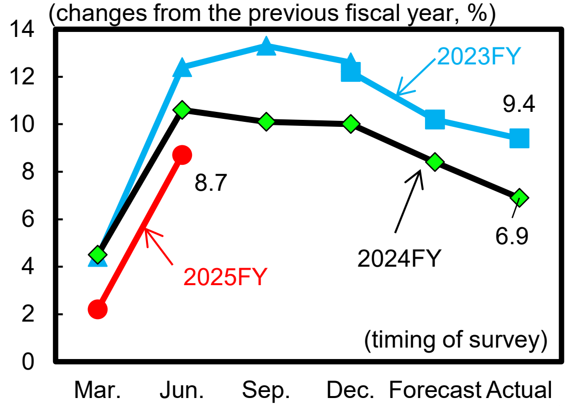


The impact of global demand on Japan's exports has decreased compared to the past but remains significant. Declining global economic activities is still a downward risk.

(Sources) Cabinet Office, Ministry of Economy, Trade and Industry, Bank of Japan, JETRO, and OECD. For details, refer to the main text (Figures 1-1-2, 5, 6, and 8).

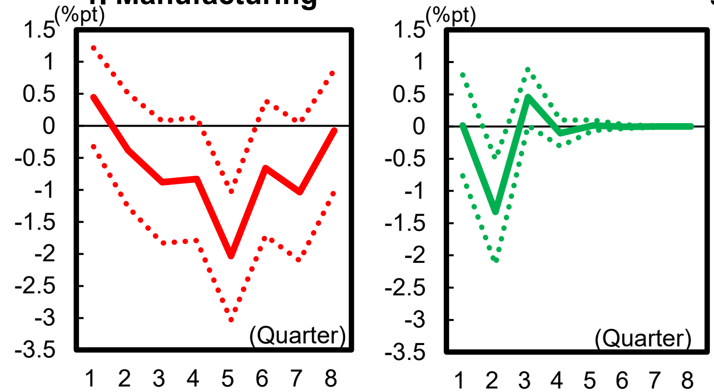
1-1: Economic Trends through Mid-2025 (2)

Figure 1: Firms' plans on investment



As of June 2025, plans on investment for the FY2025 remain solid.

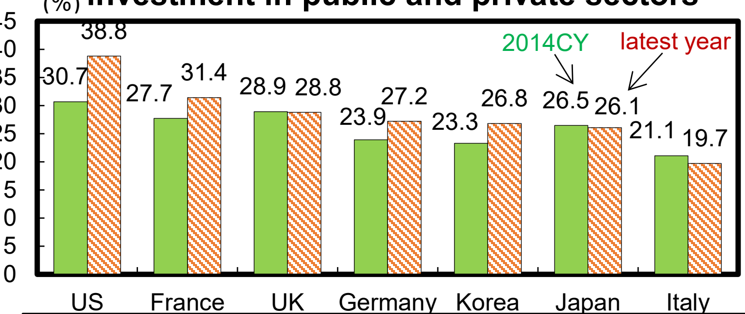
Figure 2: Impact of rising uncertainty on investment



※Impact of changes in the policy uncertainty index (1 standard deviation)

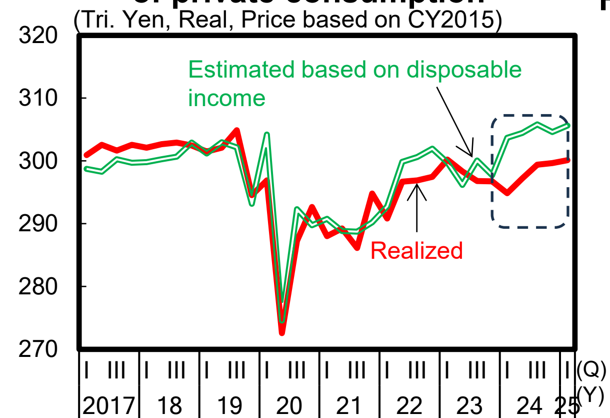
A rise in economic uncertainty may lead to a slowdown in capital investment, particularly in the manufacturing sector.

Figure 3: Share of intellectual property investment in public and private sectors



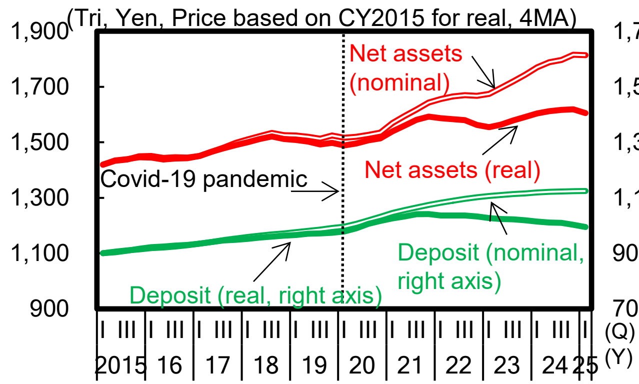
The share of intellectual property investment in public and private sectors has expanded in the U.S.and other countries over the past decade, but it has slightly decreased in Japan.

Figure 4: Predicted and actual values of private consumption



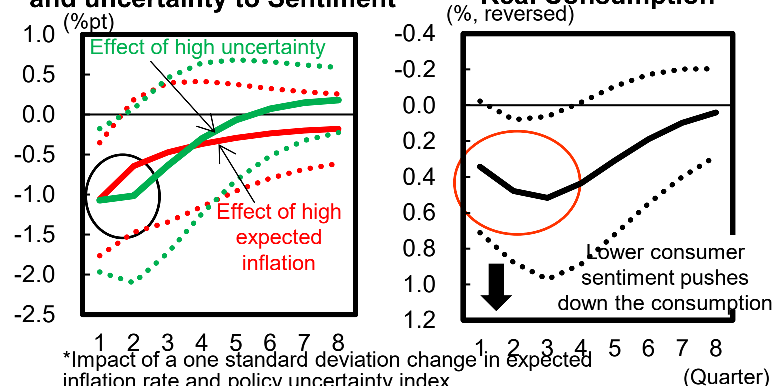
The recovery in private consumption remains moderate compared to the predicted values, accounted for by real disposable income and net financial assets, etc..

Figure 5: Households' financial asset balances



Real financial net assets in households continue to increase, but real cash and deposits have declined to near pre-pandemic levels. Promoting the "shift from savings to investtirament" remains important.

Figure 6: Background of consumer sentiment and its impact on consumption



*Impact of a one standard deviation change in expected inflation rate and policy uncertainty index.

Rises in households' expected inflation rate and economic uncertainty can temporarily dampen consumer sentiment, and a decline in sentiment significantly reduces consumption over three quarters.

(Sources) Bank of Japan,Ministry of Finance, Cabinet Office, and OECD. For details, refer to the main text (Figures 1-1-24, 25, 26, 28, 30, and 31).

1-2: Trends in Prices and Wages (1)

Figure 1: Consumer Price Index (Year-on-Year)

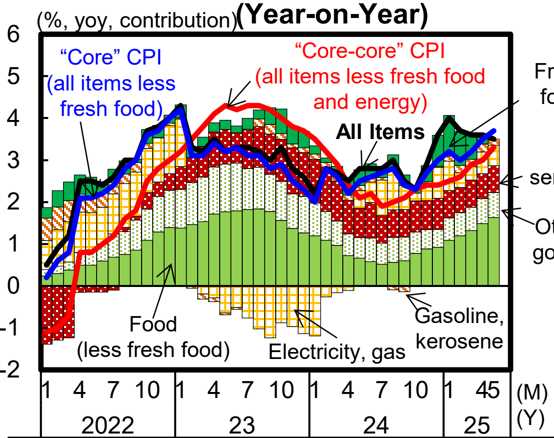


Figure 2: CPI increase rates for goods in Japan, the U.S., and Europe

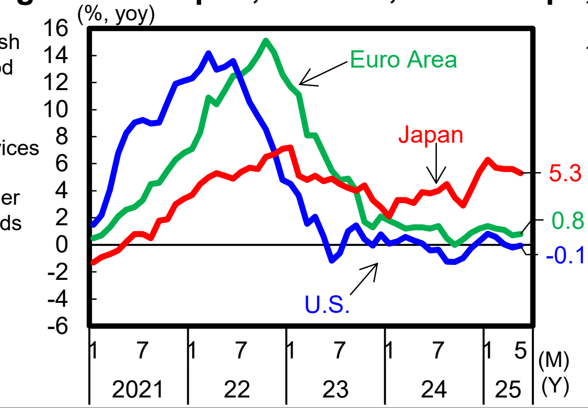


Figure 3: Food CPI(less fresh food)

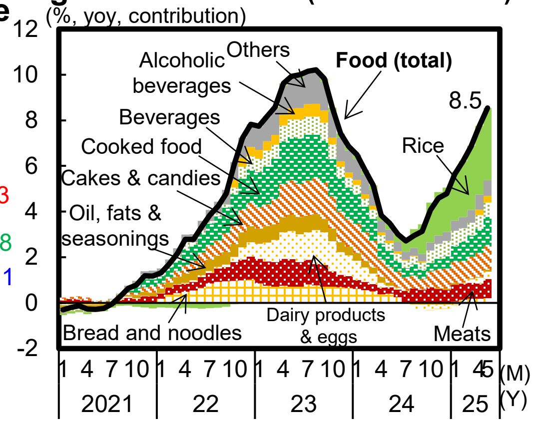
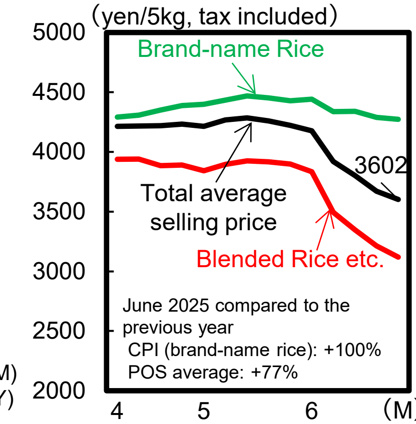


Figure 4: Rice prices at POS



Consumer prices continued to rise by over 3% (yoy) mainly led by food prices, which account for about 20% weight of CPI. While the increasing rate of goods prices settle near zero in the U.S. and Euro Area, it continues to rise at a much higher rate in Japan.

Since around autumn 2024, the increase rate in food prices has accelerated across a wide range of items, centered on rice. POS data shows that recent rice price increase has been tempered by the release of stockpiled rice.

Figure 5: Reasons for price increases by food manufacturers

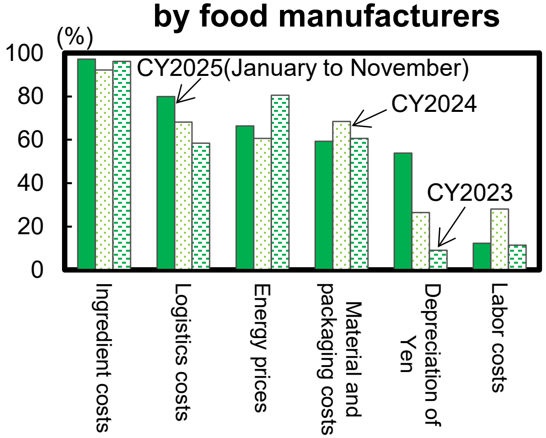


Figure 6: Import price index (yen-based)

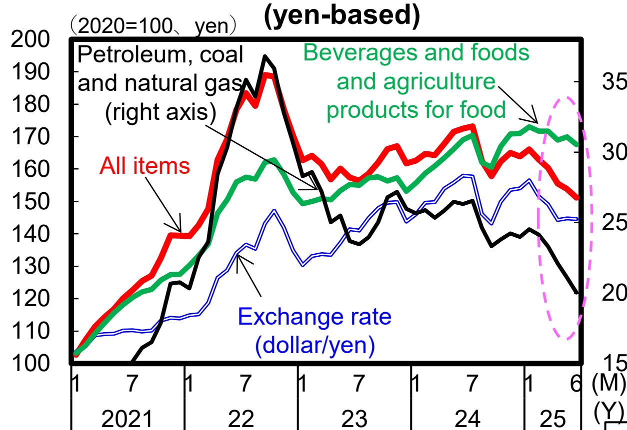
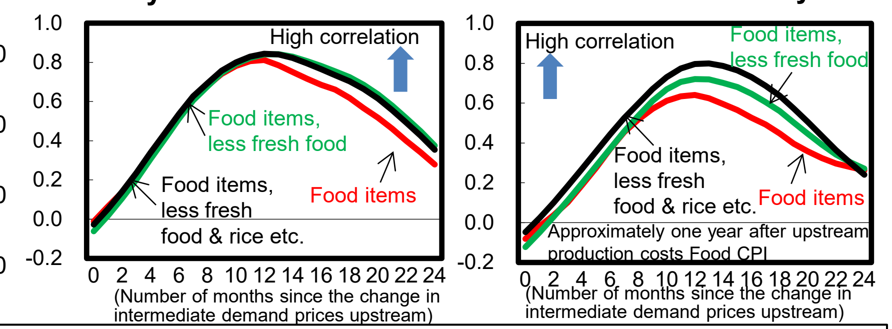


Figure 7: Time-lagged correlation between intermediate demand prices in upstream sectors and food CPI

1. January 2018 to December 2025 **2. October 2018 to May 2025**



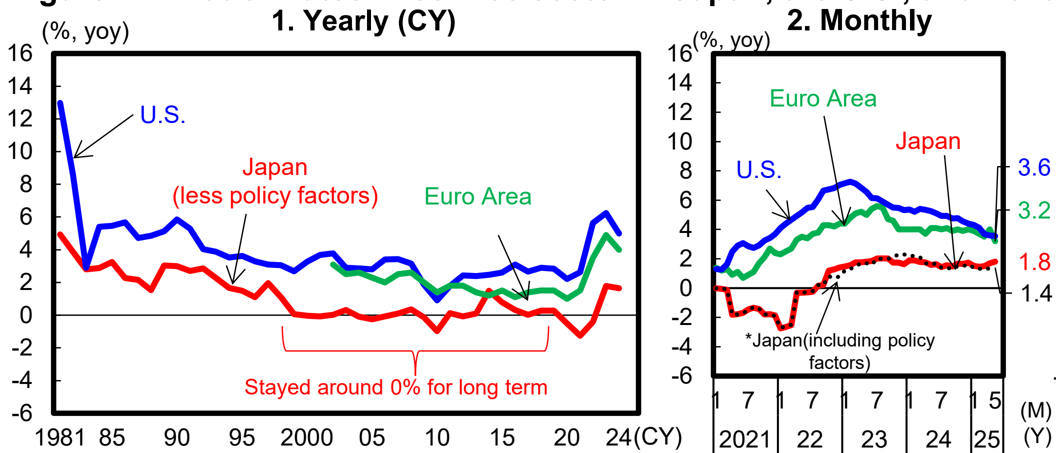
The background of food price hikes includes rising ingredient costs due to the past weakening yen, as well as rising of logistics and labor costs recently. Import prices have declined due to stabilising resource prices and the recent yen's appreciation.

Changes in upstream production costs have shown a strong correlation with the food CPI increase rate (excluding fresh food and rice) approximately one year later, and this trend has largely unchanged in recent years.

(Sources) Ministry of Internal Affairs and Communications, Ministry of Agriculture, Forestry and Fisheries, TEIKOKU DATABANK, Ltd, statistics in U.S. and Euro Area, and Bank of Japan. For details, refer to the main text (Figures 1-2-2, 6, 8, 10).

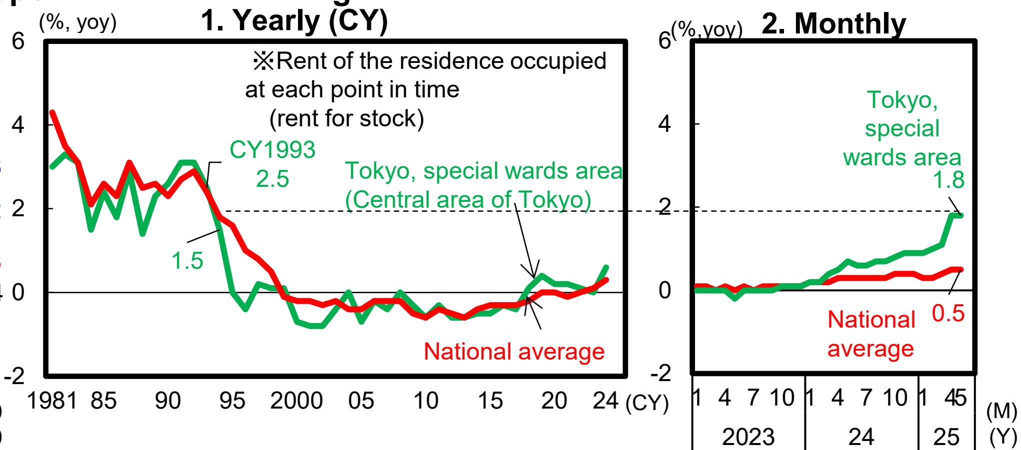
1-2: Trends in Prices and Wages (2)

Figure 1: Inflation rates in service sector in Japan, the U.S., and Europe



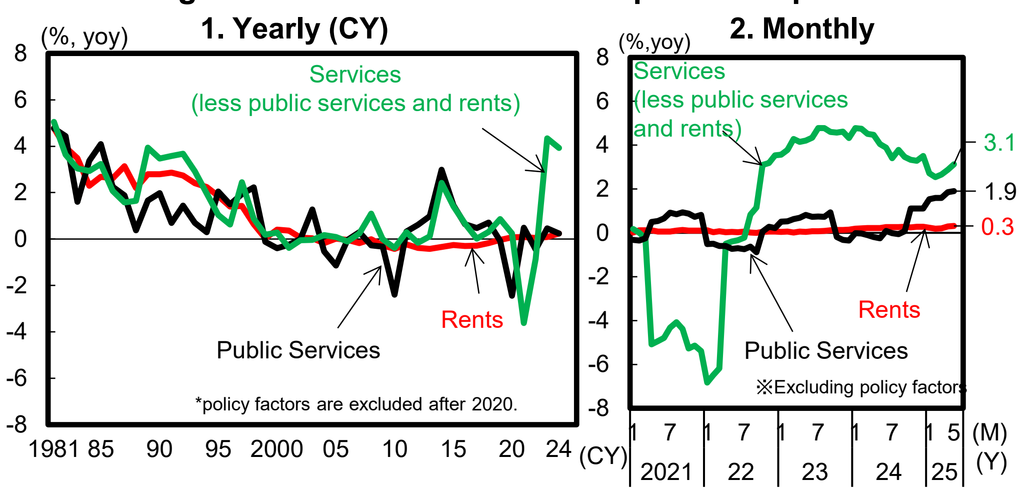
While Japan's service price has been unmoved over the long term, it has been gradually approaching 2% recently, though it remains lower than those of Europe and the United States.

Figure 3: Private rent in CPI



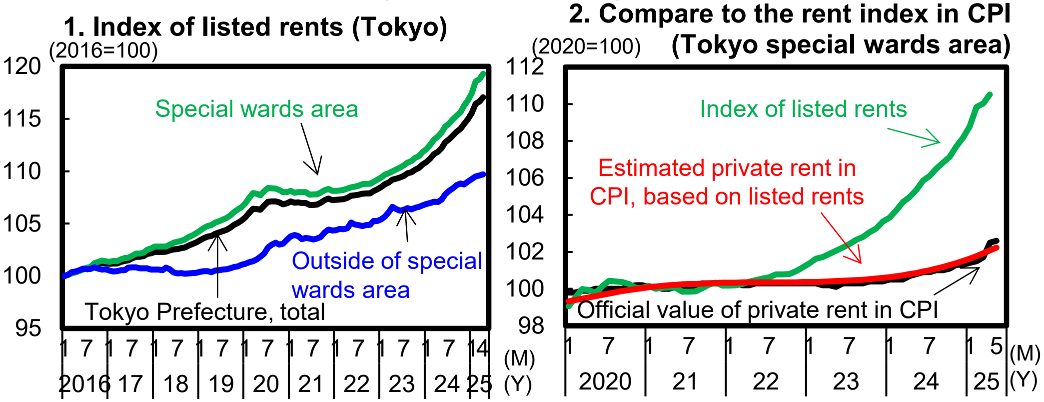
Rent inflation in CPI has remained sluggish nationwide, but in the Tokyo metropolitan area, it has seen its first increase in over 30 years due to rising of construction costs and population inflows.

Figure 2: Breakdown of service price in Japan



In Japan, service prices, excluding rent and public utilities, have been steadily rising at around 3%(yoy).

Figure 4: Big data-based price index of rent, for Tokyo special wards (estimated values)



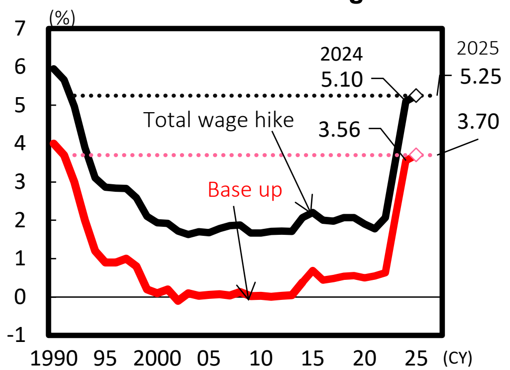
The Index of offered rents in Tokyo area has been rising rapidly in recent years, particularly in the metropolitan area. It works as a preceding index to the rent index in CPI, suggesting that rents in the metropolitan area are expected to continue increasing.

(Sources) Ministry of Internal Affairs and Communications, national statistics, and Recruit Co., Ltd. For details, refer to the main text (Figures 1-2-10, 11, and 12).

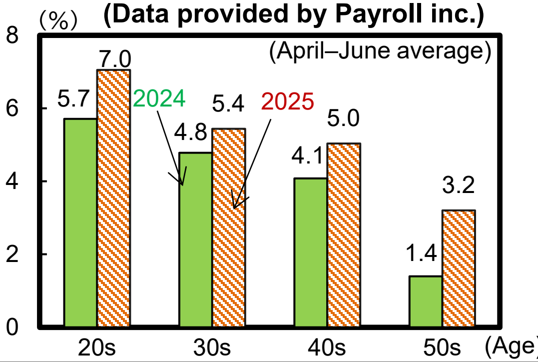
1-2: Trends in Prices and Wages (3)

Figure 1: Results of the 2025 spring wage negotiations and regular wages by age group (by big data)

1. Results of the 2025 negotiation



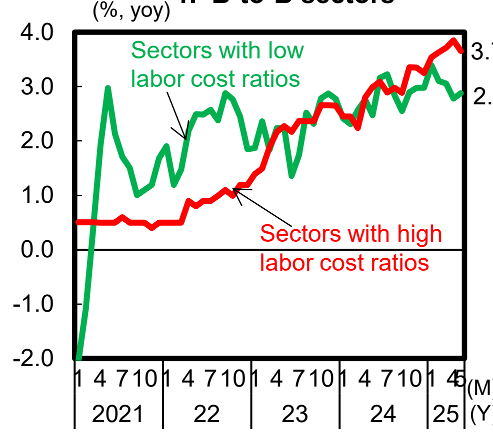
2. Regular Wage Growth by Age Group (Data provided by Payroll inc.)



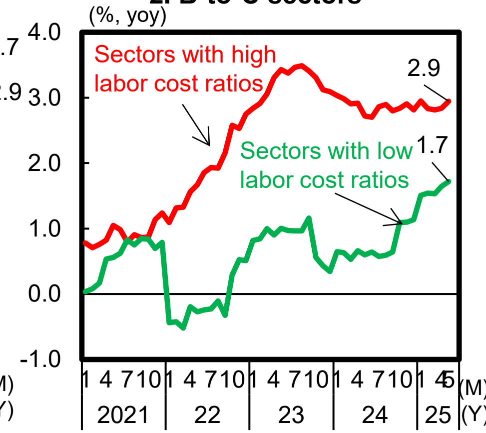
The wage increase rate in the 2025 spring wage negotiations exceeded that of the previous year. Compared to the last year, higher wage increases have spread not only to younger workers but also to middle-aged and older workers.

Figure 3: Service prices grouped by labor cost ratios

1. B-to-B sectors



2. B-to-C sectors



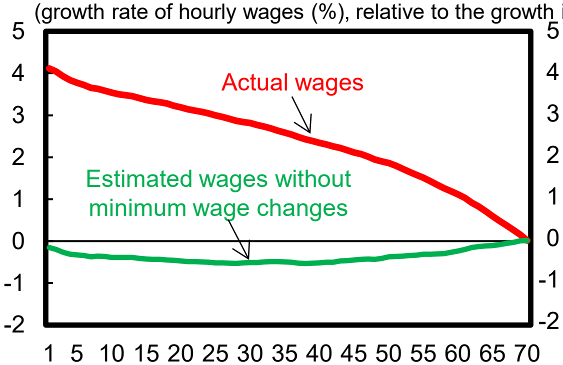
In both B-to-B and B-to-C sectors, wage cost pass-through is progressing steadily in services with high labor cost ratios.

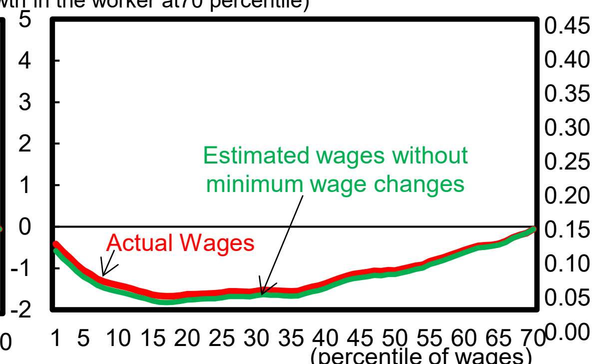
Figure 2: Effect of minimum wage increases on hourly wages for relatively low-paid part-time workers

1. Change between 2021 to 2024

2. Change between 2015 to 2019

(growth rate of hourly wages (%), relative to the growth in the worker at70 percentile)

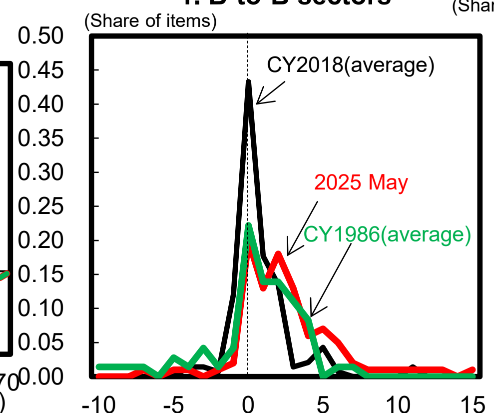




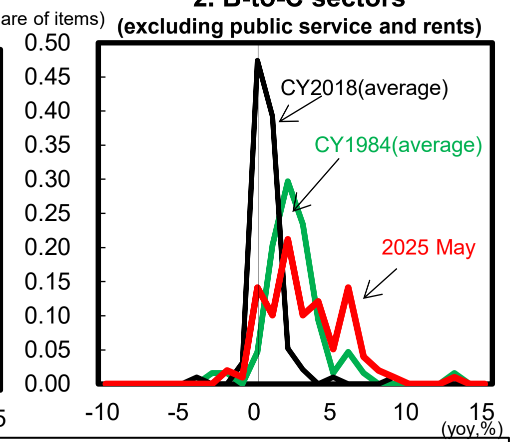
Recent increases in the minimum wage can be evaluated to have steadily lifting of the hourly wages in low-paid part-time workers, and narrowing of the overall wage distributions.

Figure 4: Distribution of price increase rates for service items

1. B-to-B sectors



2. B-to-C sectors (excluding public service and rents)

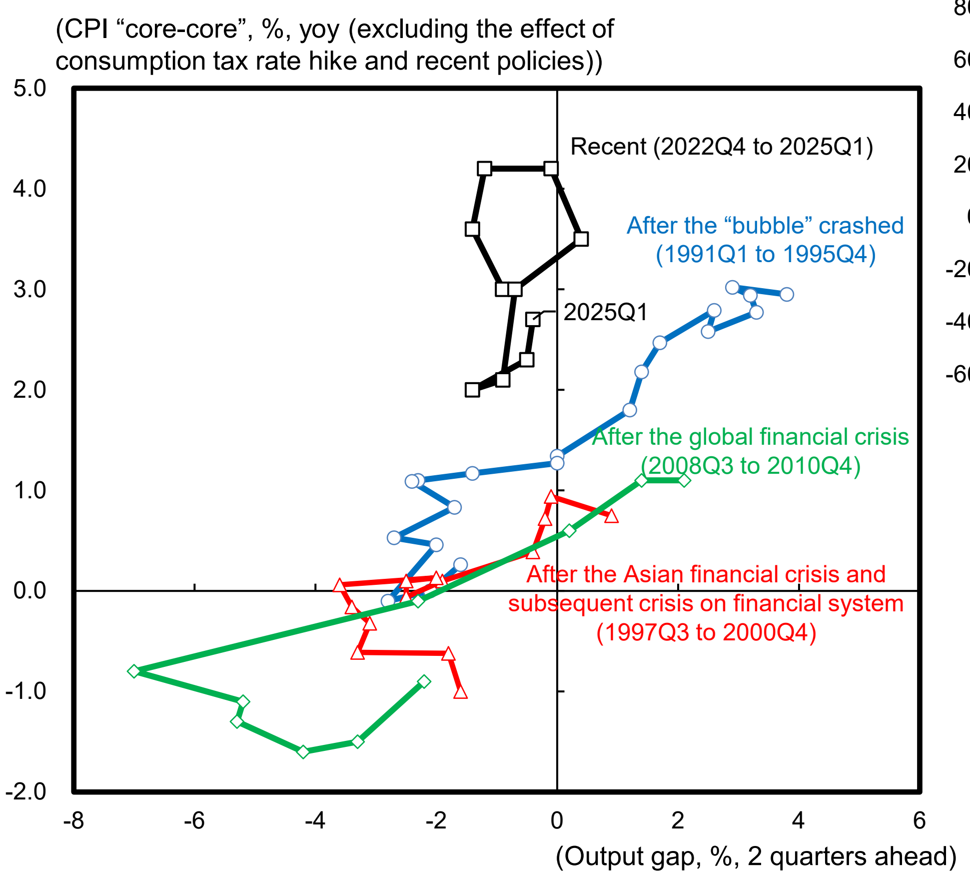


The distribution of price increase rates for service items has steadily shifted toward positive territory in recent years, approaching the levels seen in the 1980s (before the onset of deflation).

(Sources) Rengo Federation, Payroll Co., Ltd., Ministry of Health, Labour and Welfare, Ministry of Internal Affairs and Communications, and Bank of Japan. For details, refer to the main text (Figures 1-2-18, 24, 28, and 32).

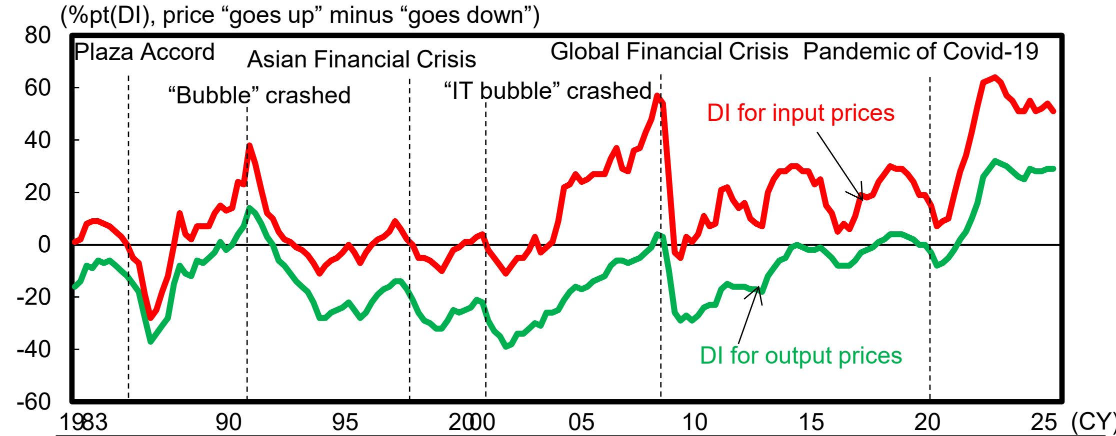
1-2: Trends in Prices and Wages (4)

Figure 1: Relationship between the output gap and the inflation rate (Phillips curve)



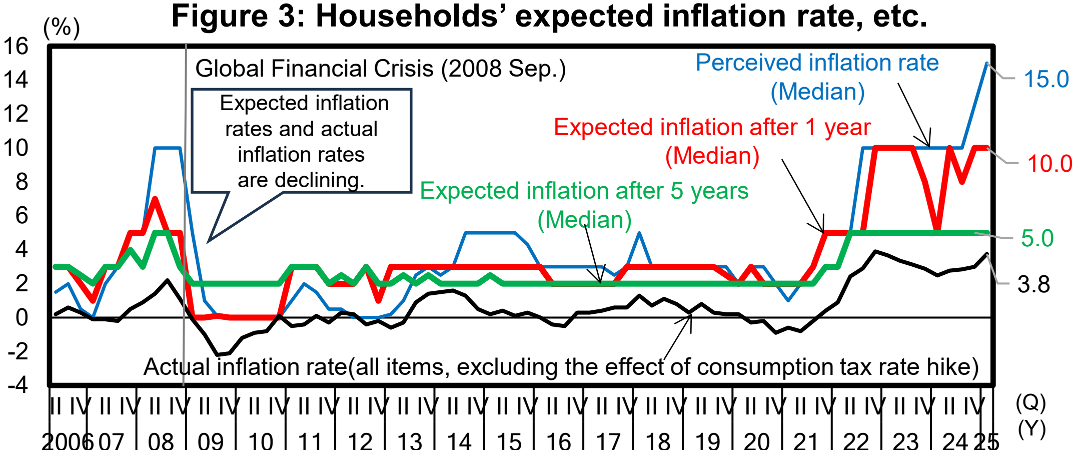
During various negative economic shocks, the output gap deteriorated, and the rate of price increase declined. However, when the Phillips curve is sufficiently positioned upward, the risk of going back to a deflation can be reduced. Establishing a norm in which both wages and prices rise steadily is important.

Figure 2: Price pass-through by businesses (Changes in input/output prices, DI)



The DI in output prices has often declined sharply during past shocks. Attention should be paid to the magnitude of the direct and indirect economic impacts of U.S. tariff measures, and their effects on pricing behavior.

Figure 3: Households' expected inflation rate, etc.



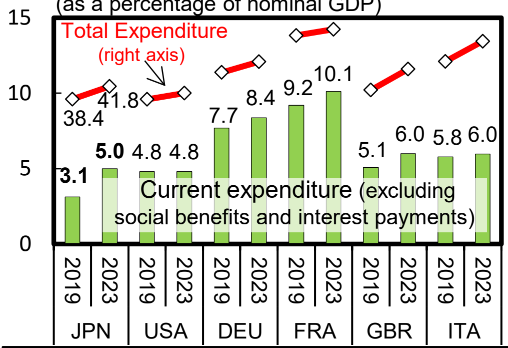
Households' expected inflation rates also declined significantly after the global financial crisis. It is essential for inflation expectations of various economic sectors to get well-anchored at stable levels.

(Sources) Ministry of Internal Affairs and Communications, Cabinet Office, and Bank of Japan. For details, refer to the main text (Figures 1-2-16, 26, and 33).

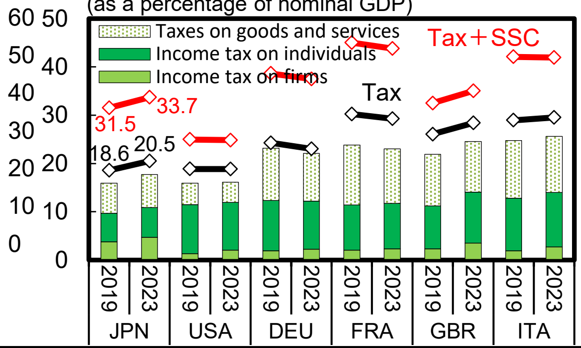
1-3: Current Situations and Challenges of Public Finance

Figure 1: General government expenditures and revenues before and after the COVID-19 pandemic

1. General government expenditure

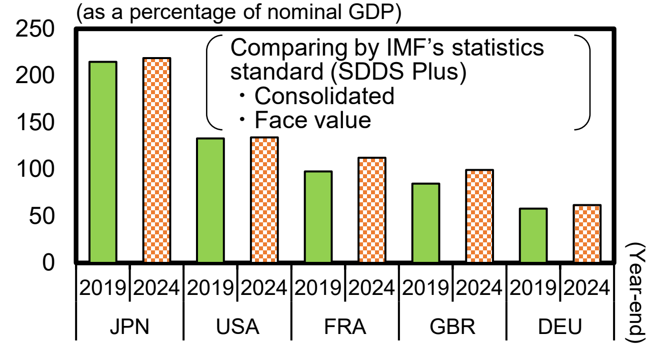


2. General government revenue

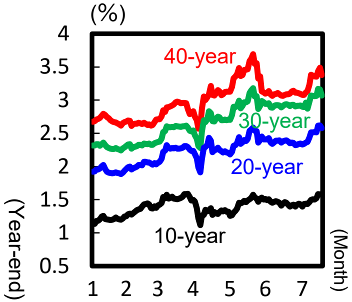


Compared to pre COVID-19 pandemic expenditure level to GDP, Japan has seen a significant increase in current expenditures including grants and subsidies. On the revenue side, the ratio of corporate income tax and indirect taxes to GDP has risen.

Figure 3: Total debt of the general government, as a percentage of GDP



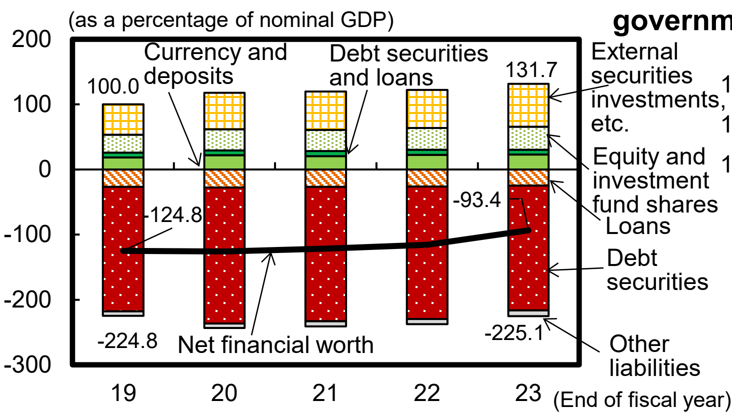
(Reference) Interest rates of government bonds (after 2025)



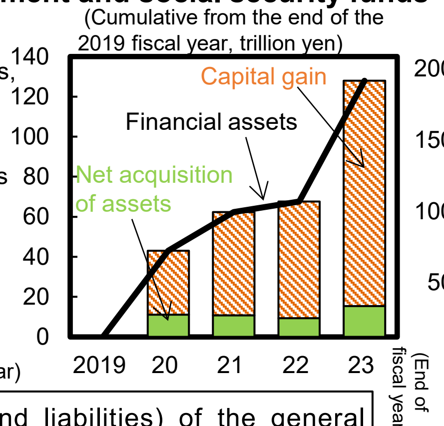
Japan's general government debt-to-GDP ratio has remained in high level, and government deb in face value has increased among all major countries compared to pre-pandemic levels. The situation warrants close monitoring, given the risk of a sharp rise in super-long-term interest rates due to an easing of supply-demand conditions from 2025 onwards, .

Figure 2: Changes in the balance of general government financial assets and liabilities and their components

1.Net financial assets and liabilities



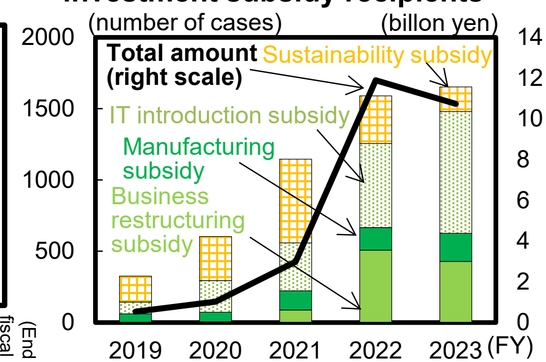
2. External securities investments by the government and social security funds



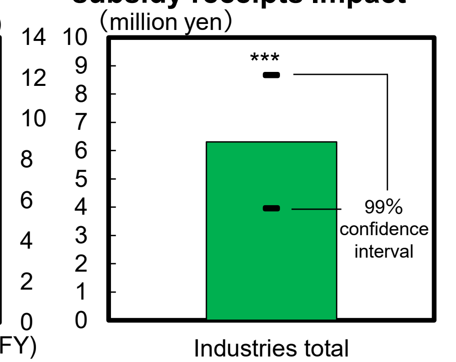
The net financial worth (difference between assets and liabilities) of the general government has improved, but this is largely due to capital (holding) gains from foreign securities investments (including the impact of the yen's depreciation).

Figure 4: Performance and effects of investment subsidies (Analysis based on cloud software accounting data)

1. Number and amount of investment subsidy recipients



2. Increase in fixed assets due to subsidy receipts Impact

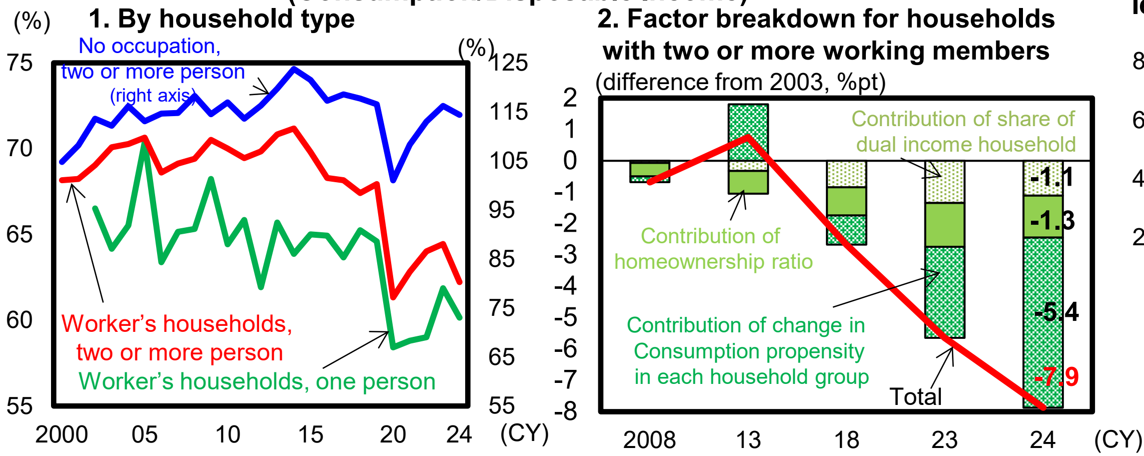


Both the number and total amount of investment subsidies received by SMEs increased through fiscal year 2022, based on a new big data. These subsidies may have had some investment-inducing effects.

(Sources) Cabinet Office, OECD, national statistics, Bloomberg, and Money Forward Co., Ltd. For details, refer to the main text (Figures 1-3-3, 5, 8, 9, 13, 17, and Column 1-5).

2-1: Toward a Recovery in Private Consumption (1)

Figure 1: Average propensity to consume (Consumption/Disposable Income)



The average propensity of consumption has generally declined. By 2024, it declined significantly due to factors other than the changes in the share of household types.

Figure 3: Changes in Environment leading to increased consumption

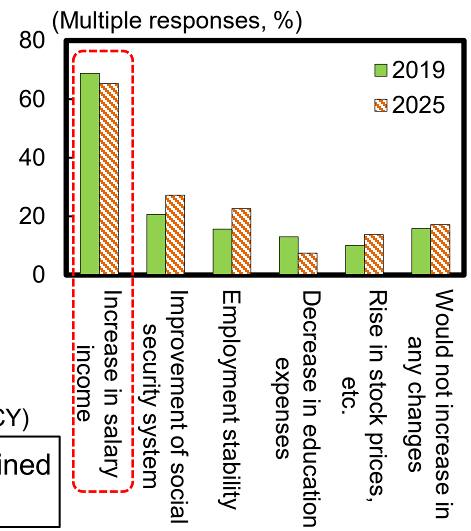


Figure 4: Increase in consumption in response to temporal and sustained income increase (by 10%)

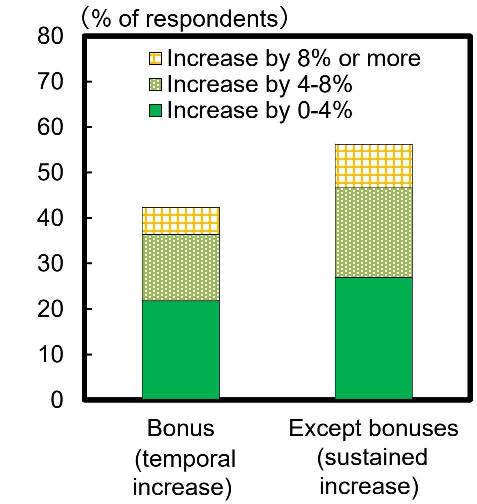
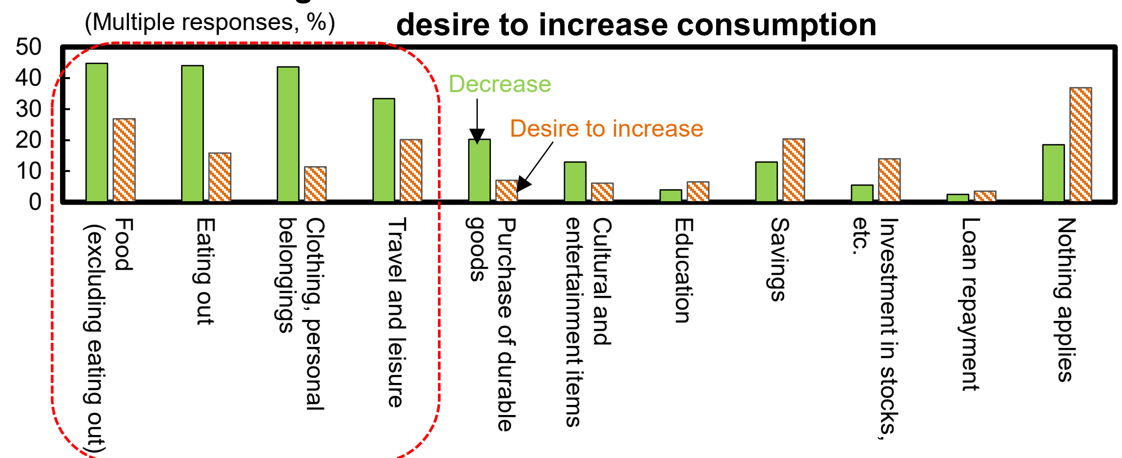
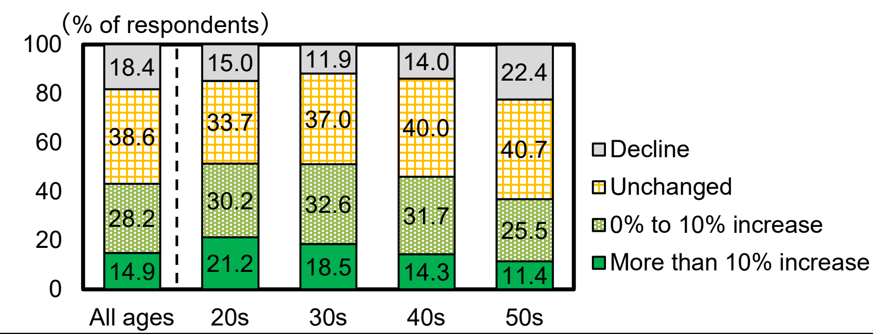


Figure 2: Areas where households decrease/have desire to increase consumption



While more households are cutting back on expenses such as food due to rising prices, households that are currently holding back also have a latent desire to increase consumption in those same areas.

Figure 5: Expected increase in households' wage income over the next five years



While increases in wage income, particularly sustained wage growth, are crucial for consumption growth, nearly 40% of households (around 30% even among younger households) expect their wages to remain at current levels in the coming years. Establishing a norm for wage increases is essential.

(Sources) Ministry of Internal Affairs and Communications and Cabinet Office. For details, refer to the main text (Figures 2-1-1, 2-1-2, 2-1-3, 2-1-5, 2-1-6, and 2-1-7).

2-1: Toward a Recovery in Private Consumption (2)

Figure 1: Expected inflation rate and consumer sentiment

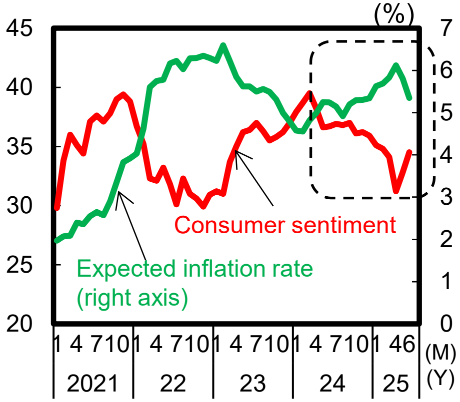


Figure 2: Expected inflation rate, one year ahead

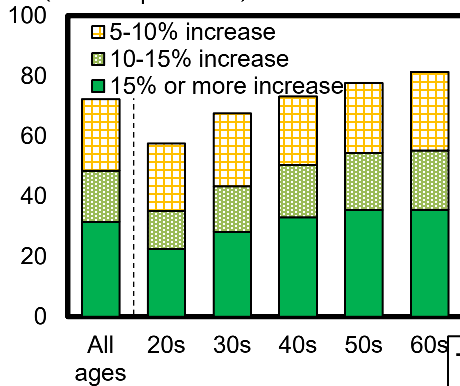
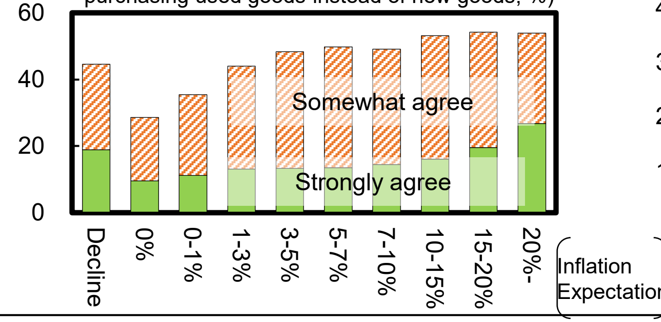


Figure 5: Expected inflation rate and willingness of used goods consumption



The higher the expected inflation rate, the stronger the preference for second-hand goods consumption.

Figure 6: Perceptions of the amount of financial assets

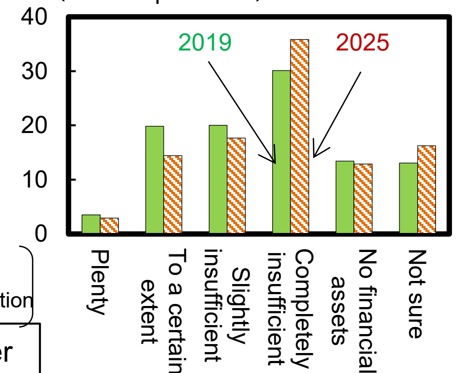


Figure 3: Importance of the inflation rate over the past year in forming expected inflation rate (adaptive expectation formation)

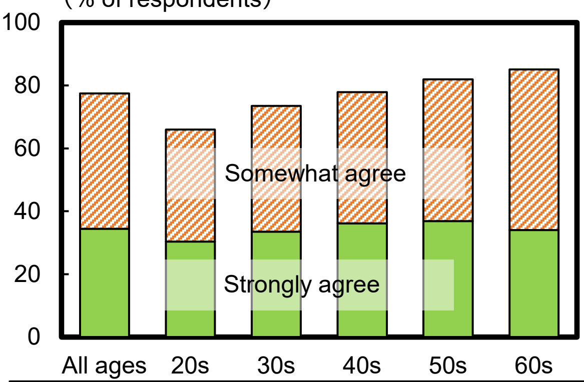


Figure 4: Degree of bringing forward consumption of durable goods based on price increase expectation

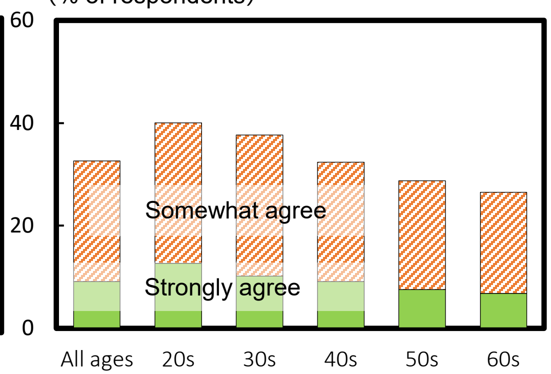


Figure 7: Purpose of savings

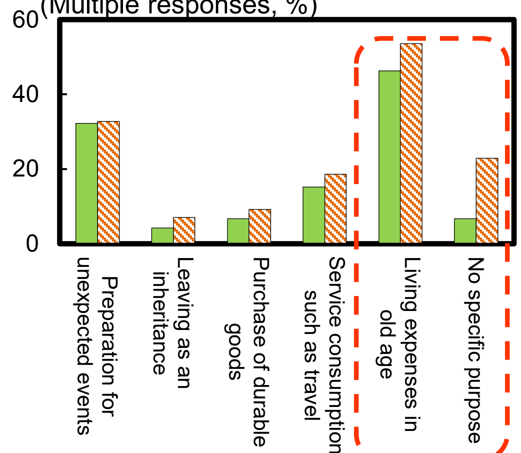
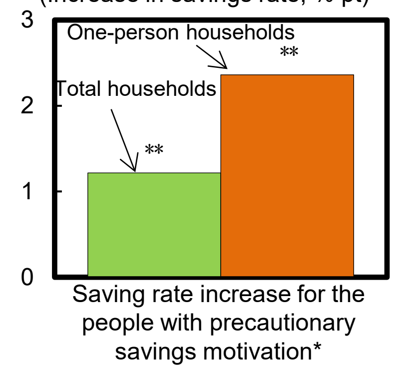


Figure 8: Preparations for the future and the effect on saving



Saving rate increase for the people with precautionary savings motivation*

*People who answered "preparation for unexpected events" as a reason for saving

The recent stagnation in the recovery of consumption has been partly driven by rising inflation rates. Notably, expected inflation tends to be higher among elderly people, which may reflect the influence of adaptive expectation mechanism. Moreover, elderly people appear less likely to bring forward purchases of durable goods in response to higher expected inflation, which could be one factor behind the weakness in aggregate consumption.

The number of households reporting that their financial assets are completely insufficient has increased compared to pre-pandemic. The number of households who are saving due to concerns about the future, such as living expenses after retirement, has increased. Through precautionary motivation, the savings rate has been pushed up, particularly among one-person households.

(Sources) Cabinet Office. For details, refer to the main text (Figures 2-1-10, 11, 12, 17, 21, 22, 24, and Column 2-1-5).

2-2: Toward Sustained Wage Increases (1)

Figure 1: Wage increase rates by wage level (Full-time workers)

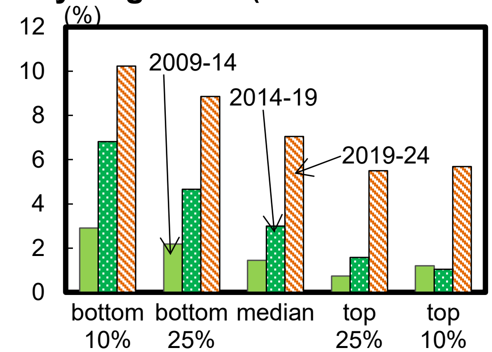
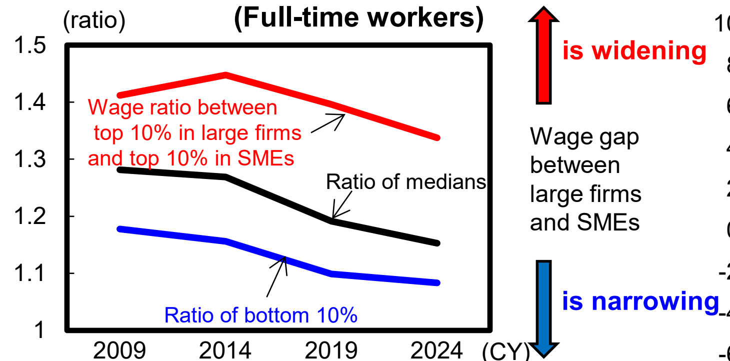
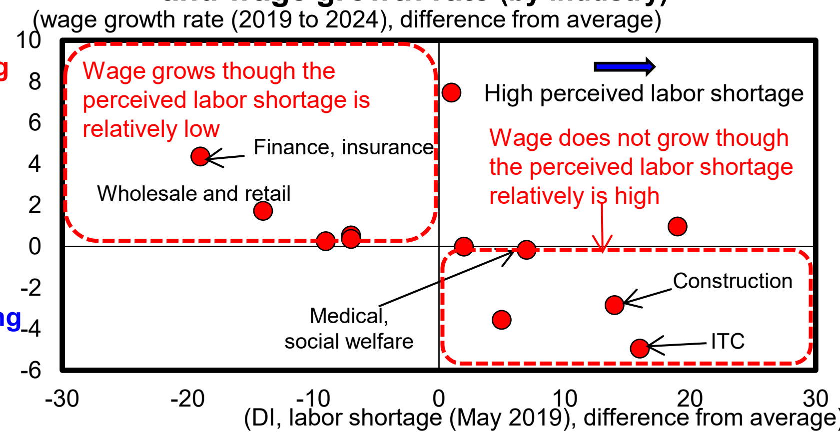


Figure 2: Wage gap between large firms and small/medium-sized enterprises (Full-time workers)



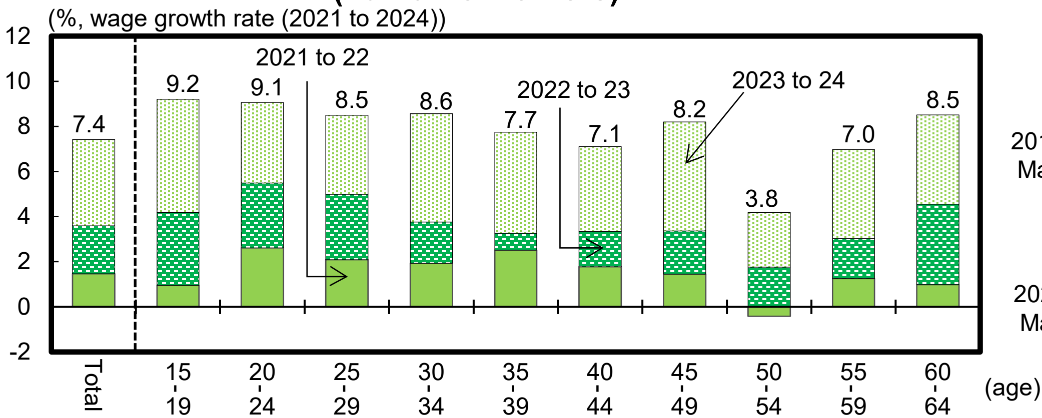
Wage increase rates are higher for workers with relatively lower wage levels, and wage gaps are narrowing. The wage gap between large firms and SMEs is also showing a narrowing trend. However, attention should be given that signs of a polarization in wage increasing rate are emerging among SMEs.

Figure 4: Perceived labor shortage and wage growth rate (by industry)



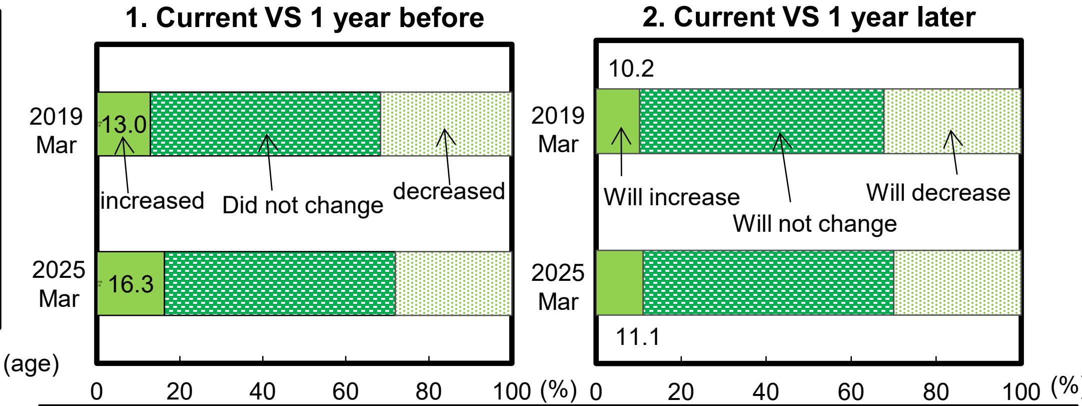
In industries such as healthcare, welfare, and construction, which are sensitive to public sector demand, wage increase rates remain low despite high labor shortages. Policy measures are needed in sectors where market mechanisms function less efficiently.

Figure 3: Regular wage increase rates, by age group (Full-time workers)



Wage growth rates tend to be higher among younger workers, but in 2024, wage increases have spread to some extent among middle-aged workers as well.

Figure 5: Perceived increase in household income

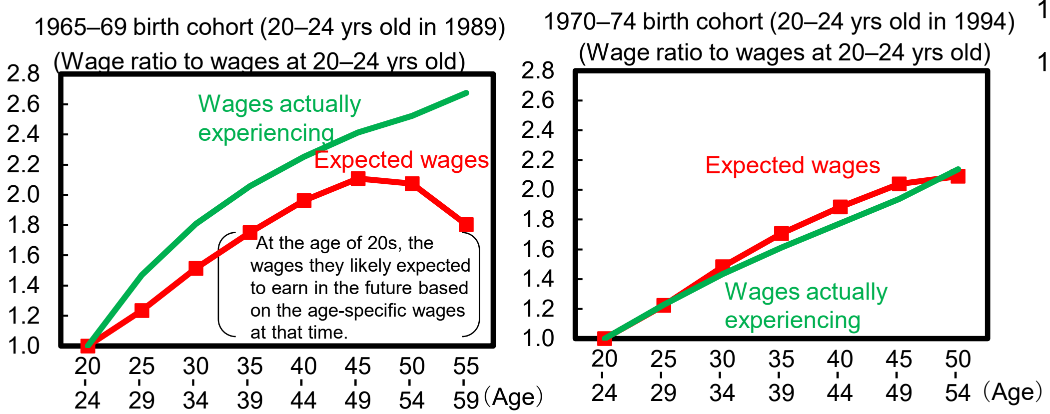


Despite the rise in nominal wage growth rates, the number of consumers who feel their income has increased has not risen significantly, and survey results suggest that the perceived wage growth is not yet widespread.

(Sources) Ministry of Health, Labour and Welfare and Bank of Japan. For details, refer to the main text (Figures 2-2-2, 3, 6, 8, and 11).

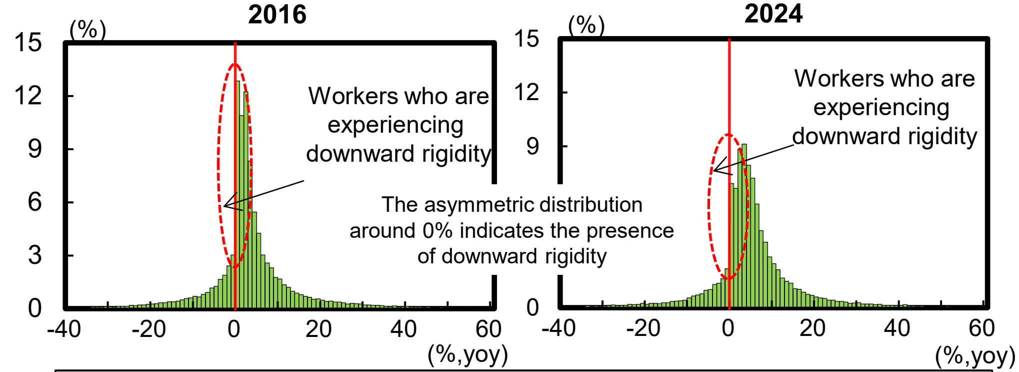
2-2: Toward Sustained Wage Increases (2)

Figure 1: Expected and actually experiencing wages by cohort (males)



Unlike the older cohorts, actual wages may have remained lower than the expected wages based on the wage curve for several subsequent cohorts.

Figure 4: Distribution of wage increase rates and downward rigidity



Over the past decade, while the distribution of wage increase rates has become more concentrated in positive territory, downward rigidity in wages has weakened but remains present.

Figure 2: Wages for those who remained at the same company from graduation (males)

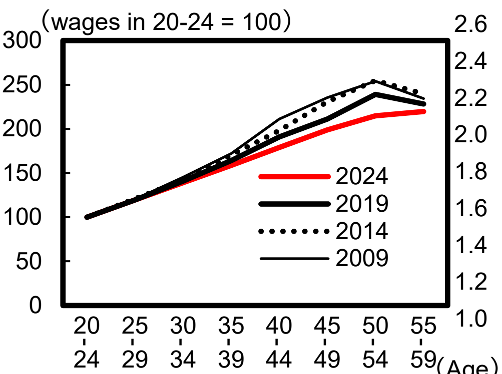
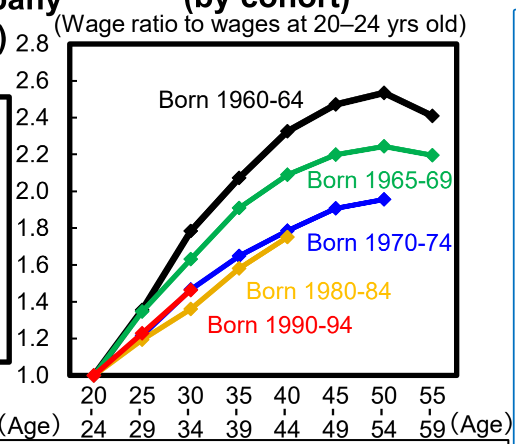
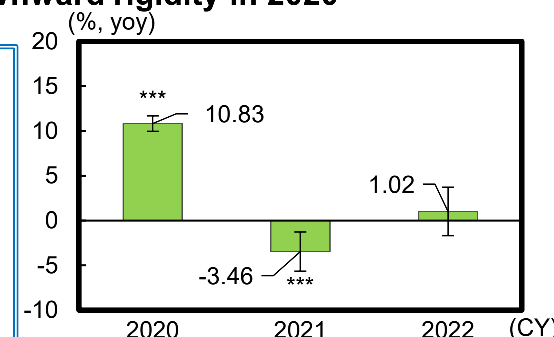


Figure 3: Real wages (by cohort)



The degree of wage increases by tenure declined over the past 15 years. Cohort-specific wage curve in real terms also flattened over the generation. Realizing stable inflation and higher wage hike is essential.

Figure 5: Upward rigidity of wages for workers who experienced downward rigidity in 2020



Workers who experienced downward wage rigidity in 2020 saw slower wage increase in 2021, as their wage levels remained elevated (upward rigidity). However, this effect may have already disappeared by 2022.

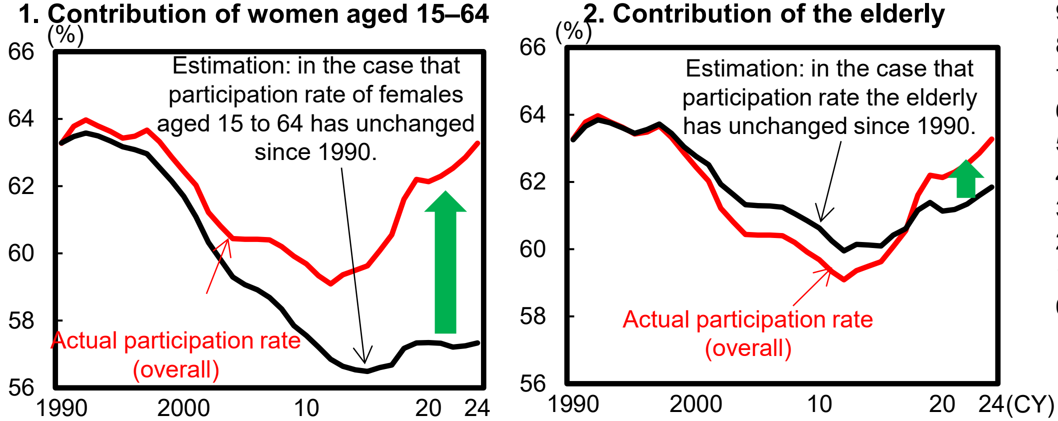
Downward and upward rigidity of wages

- Under conditions of low wage growth, **it is difficult to reduce wages (downward rigidity)**, and companies that did not reduce wages during an economic downturn may face two challenges: (1) they may be unable to sufficiently raise wages during the subsequent recovery phase, and (2) they may become reluctant to raise wages due to concerns about the difficulty of future wage cuts (**upward rigidity**). **This is a phenomenon specific to deflationary conditions**.
- In fact, wage increase rates for workers who experienced downward rigidity during the **global financial crisis** remained suppressed for some time afterward.

(Sources) Ministry of Health, Labour and Welfare, Ministry of Internal Affairs and Communications, and Panel Data Research Center at Keio University. For details, refer to the main text (Figures 2-2-14, 15, 16, 18, and 21).

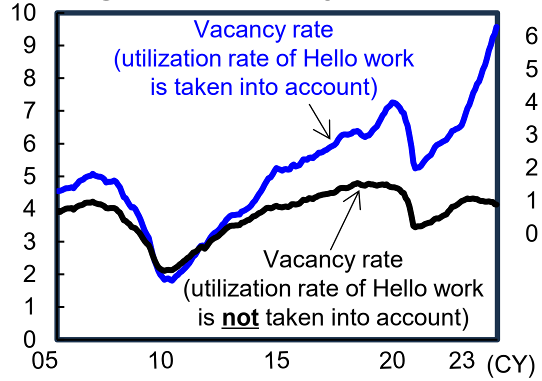
2-3: Long-term Changes and Challenges in the Labor Market (1)

Figure 1: Labor participation rates and contributions of females and the elderly's participation



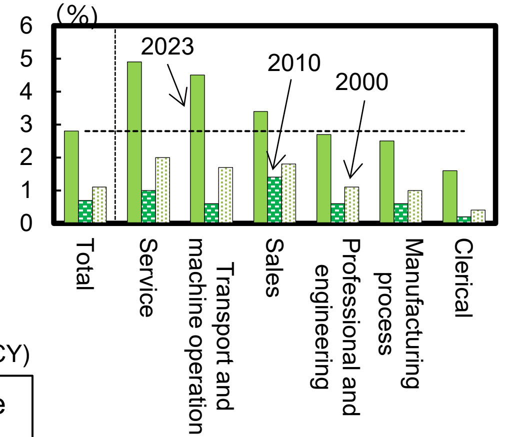
Since the first half of the 2010s, the increase of labor participation among females and the elderly has led to an increase in the overall labor participation rate, with the labor force population continuing to grow.

Figure 3: Vacancy rate



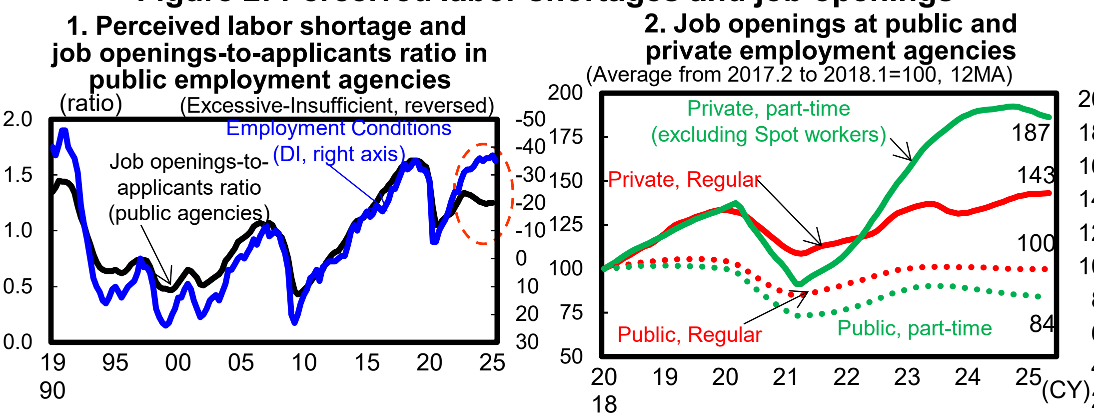
The vacancy rate has been on the rise since the latter half of the 2010s, once the decline in utilization rate of "Hello Work" (public employment agencies) is taken into account.

Figure 4: Vacancy rates by job types



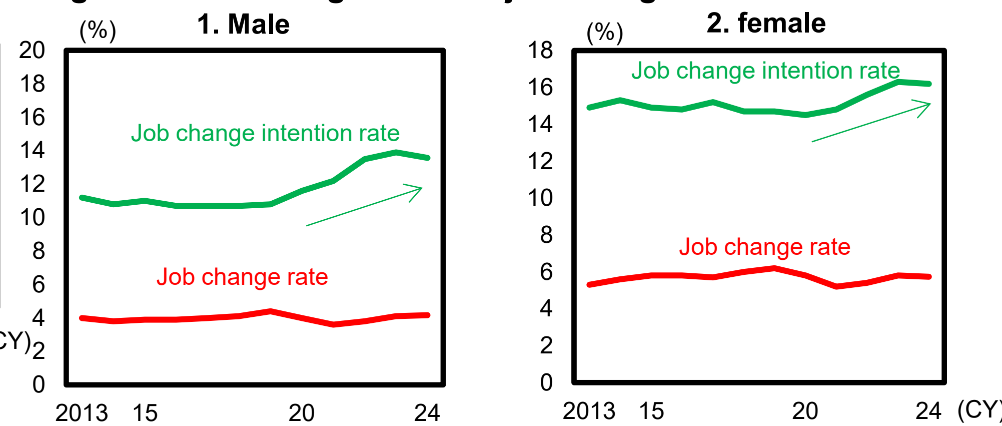
The vacancy rate exhibits notable variations across job types, suggesting an increasing labor market mismatch.

Figure 2: Perceived labor shortages and job openings



Despite a historically high perceived labor shortage, the job openings-to-applicants ratio has remained flat, showing a divergence between two statistics. This is largely attributable to the shift in job postings from "Hello work (public employment agencies)" to private employment agencies.

Figure 5: Job change rate and job change intention rate

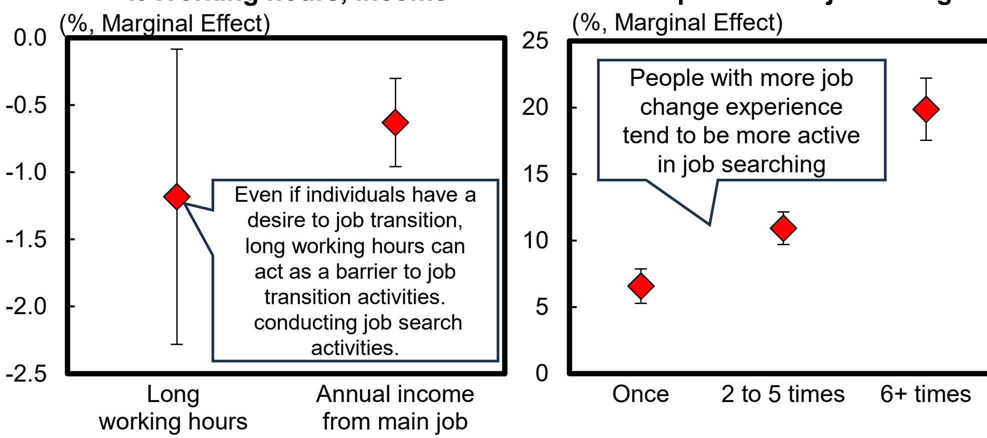


While the ratio of those who have a desire for job changes has increased for both male and female, the rate of actual job change has remained stable.

(Sources) Ministry of Internal Affairs and Communications, Ministry of Health, Labour and Welfare, Bank of Japan, and Nowcast Co., Ltd.. For details, refer to the main text (Figures 2-3-4, 7, 11, 13, 14, and 16).

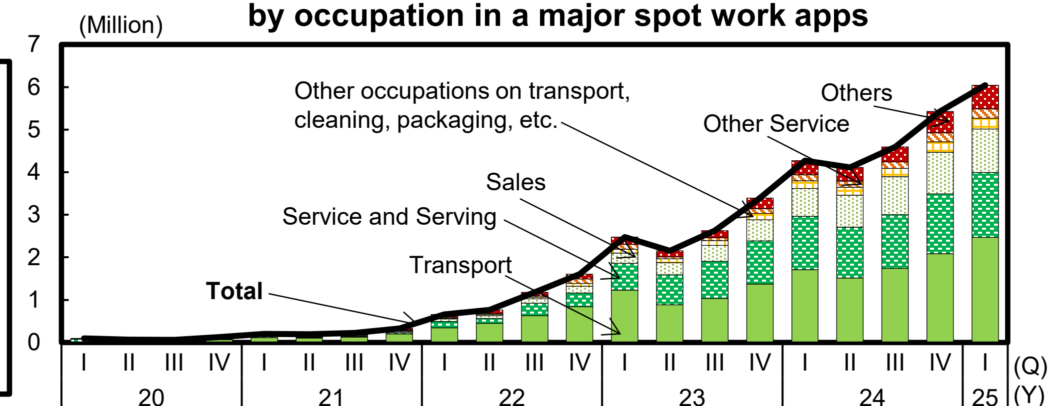
2-3: Long-term Changes and Challenges in the Labor Market (2)

Figure 1: Factors influencing the rate of job search activities



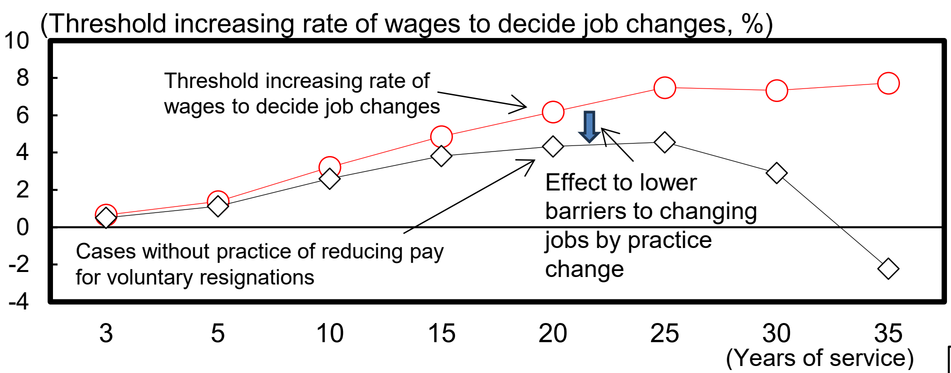
Addressing long working hours and offering support for those with no job change experience may lower the barriers to job search activities.

Figure 3: Number of job openings by occupation in a major spot work apps



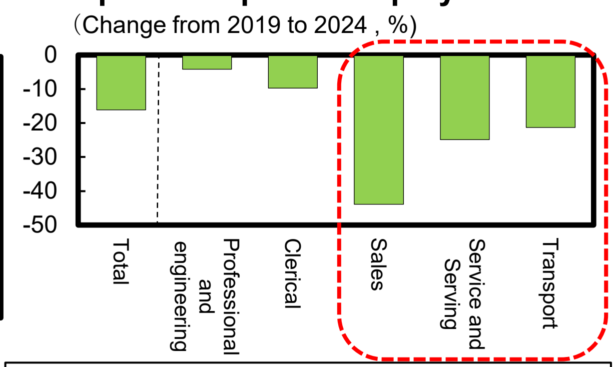
Spot work, which involves short-term or one-off jobs, has grown as it aligns with the preferences of workers seeking to utilise their spare time and companies aiming to secure workers flexibly. Postings of jobs have exceeded 6 million per quarter, large part of which are transportation, serving, and sales.

Figure 2: Impact of the practice of reducing retirement allowance on job change incentives



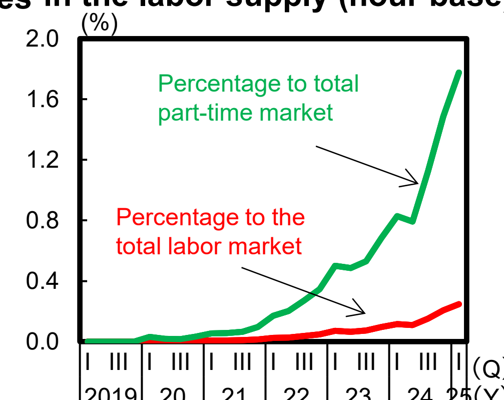
The practice of reducing retirement allowance for voluntary resignation may lead job seekers to demand higher salaries for their new positions, thereby dampening incentives to change jobs.

Figure 4: Part-time job postings by occupation at public employment offices



Job postings at public employment agencies are decreasing in job types where postings of spot work are increasing, suggesting a possible shift in recruitment channels.

Figure 5: Share of spot work in the labor supply (hour base)



Spot workers are estimated to account for over 1% of total part-time labor hours.

(Sources) Recruit Works Institute, Central Labor Relations Commission, data provided by Timee Co., Ltd., Ministry of Internal Affairs and Communications, and Ministry of Health, Labour and Welfare. For details, refer to the main text (Figures 2-3-18, 20, 22, 23, and 25).

3-1: Changes and Challenges in relationship between Japan and the Global Economy (1)

(trade balance)

Figure 1: Trends in the trade balance

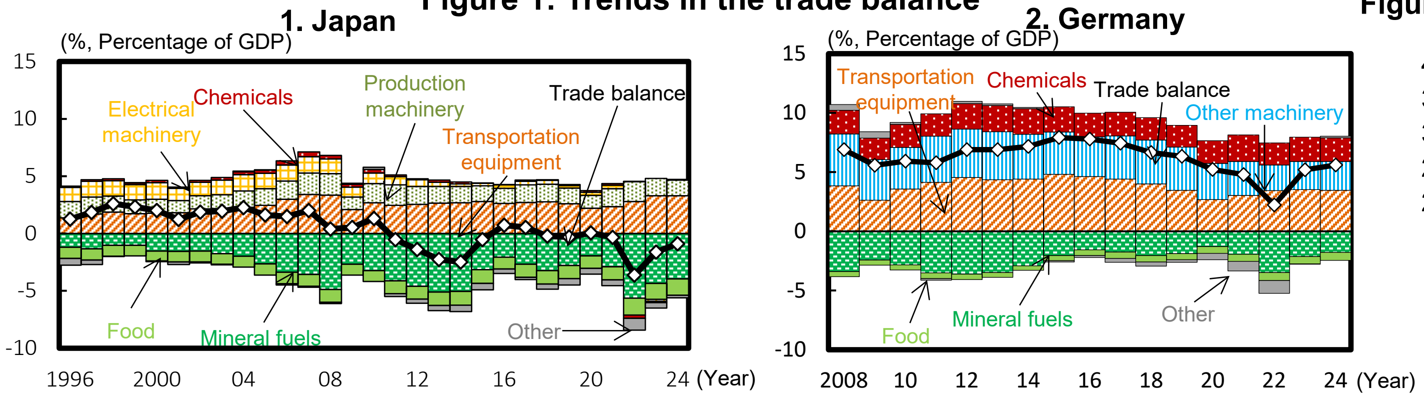
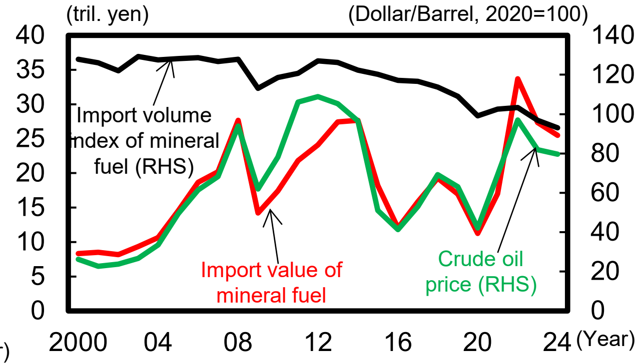
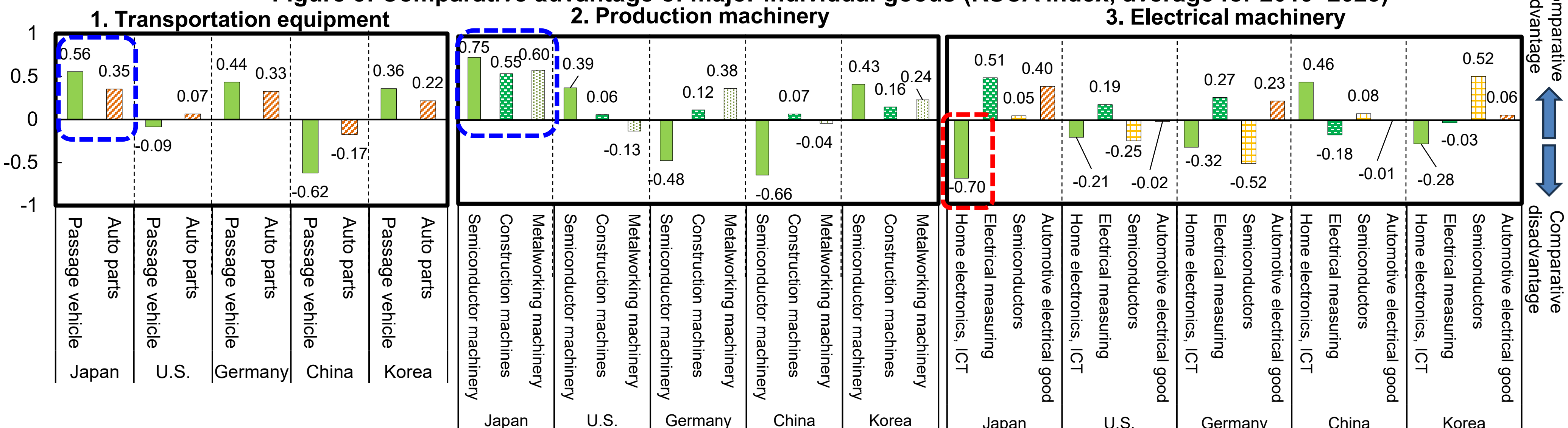


Figure 2: Mineral fuel imports and crude oil prices



Japan’s trade balance has shifted from a surplus to a roughly balanced state over a long term. In contrast, Germany, which had a similar trade balance structure, maintains a trade balance surplus. Although Japan has reduced its import volume of crude oil and other commodities through improvements in energy efficiency, high dependency on imports makes the country vulnerable to fluctuations in natural resource prices, resulting in trade deficits and a structure prone to outflows of real income to overseas.

Figure 3: Comparative advantage of major individual goods (RSCA index, average for 2019–2023)



Japan’s competitiveness has declined in home electronics and ICT equipment, while maintaining comparative advantages in passage vehicles and their parts, semiconductor machinery, and construction machines and metalworking machinery.

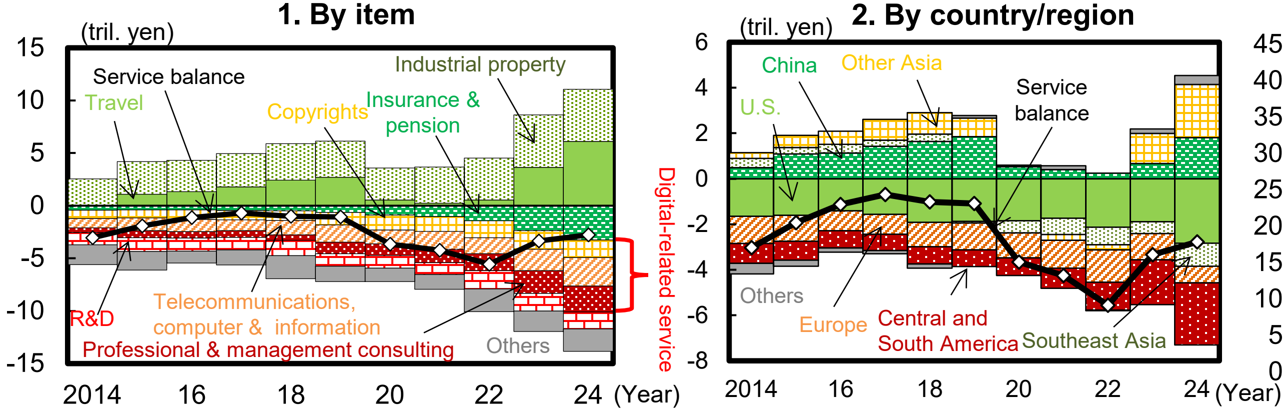
(Sources) Ministry of Finance, Cabinet Office, the Federal Statistical Office of Germany, Bloomberg, and UN Comtrade. For details, refer to the main text (Figures 3-1-3, 5, and 8).

3-1: Changes and Challenges in relationship between Japan and the Global Economy (2)

(Service Balance and Income Balance)

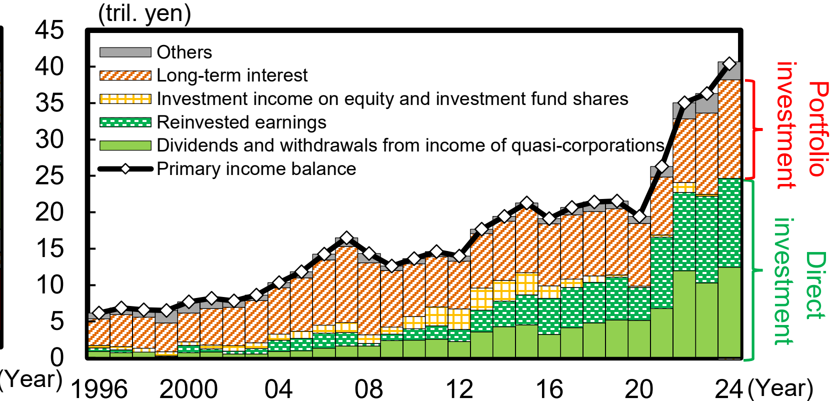
Figure 1: Trends in the services balance

1. By item / 2. By country/region



While increasing inbound consumption and royalty income from overseas affiliates contributed to the expansion of the surplus, deficits widened in digital-related services and insurance. By region, deficits has widened in trade with the United States and Latin America.

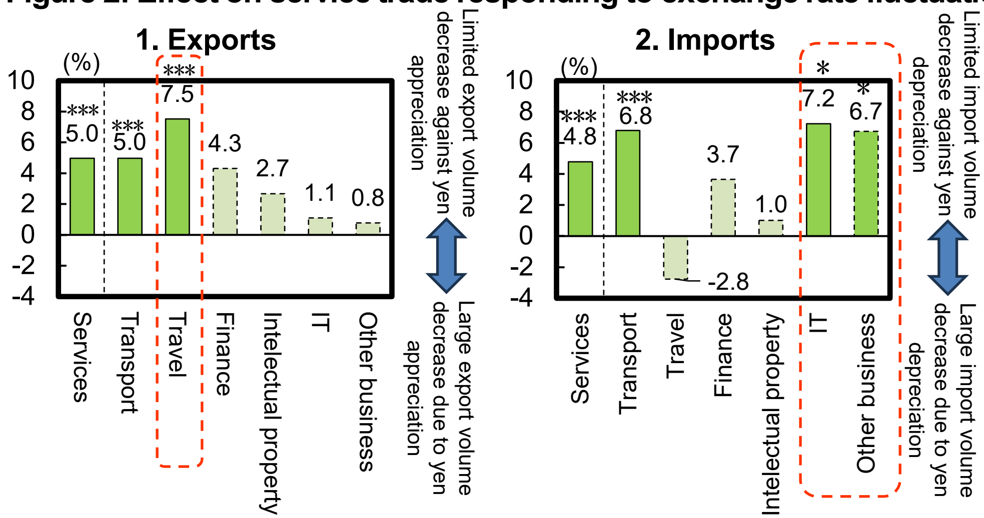
Figure 3: Trends in primary income balance



Amid the ongoing shift of production bases overseas, the primary income surplus has expanded mainly driven by direct investment with the yen depreciation also contributing to the trend.

Figure 2: Effect on service trade responding to exchange rate fluctuations

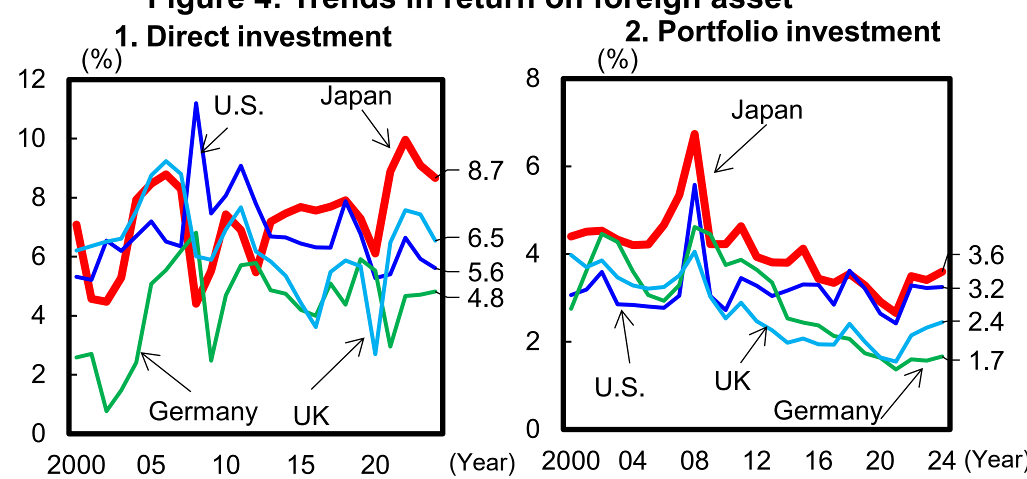
1. Exports / 2. Imports



While travel export tends to remain resilient even during yen appreciation, digital-related service tends to maintain steady import level even during yen depreciation.

Figure 4: Trends in return on foreign asset

1. Direct investment / 2. Portfolio investment



As companies sought higher returns, overseas assets have accumulated and the rates of return tended to be higher than those in other countries. A significant portion of these overseas investments may be reinvested.

(Sources) Ministry of Finance, Bank of Japan, Cabinet Office, Ministry of Internal Affairs and Communications, International Monetary Fund, Bloomberg, Deutsche Bundesbank, U.S. Department of Commerce, and UK Office for National Statistics. For details, refer to the main text (Figures 3-1-9, 11, 16, 21, and Column 3-2-1).

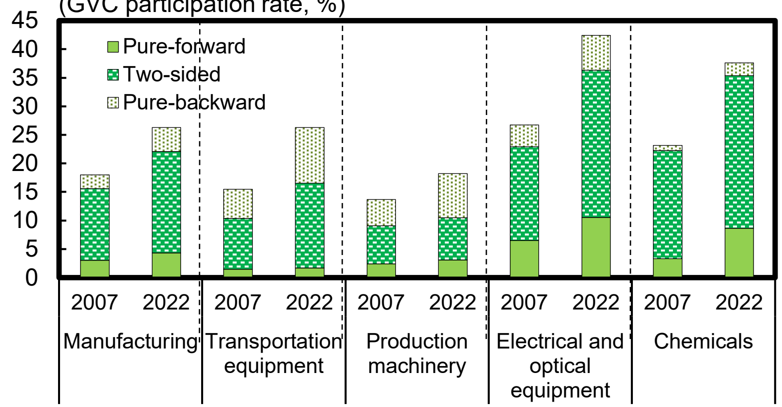
3-1: Changes and Challenges in relationship between Japan and the Global Economy (3)

(Global Value Chain (GVC) participation rate & Importance of Free Trade)

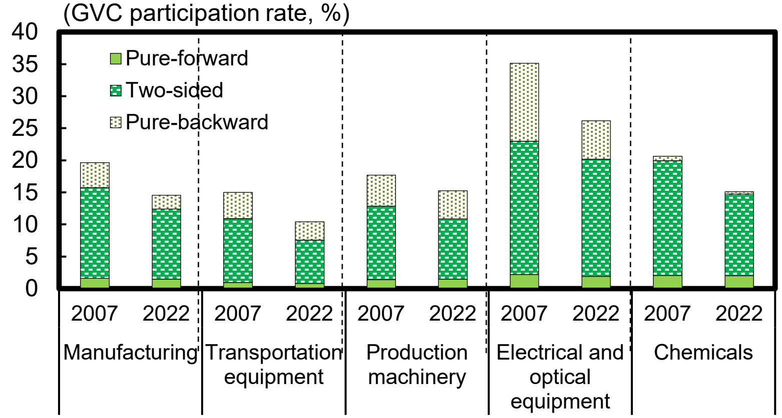
Figure 1: Participation in GVC-related Output

Pure-forward: Participation at the starting point of the supply chain
Two-sided: Participation at the intermediate point of the supply chain
Pure-backward: Participation at the final point of the supply chain

1. Japan



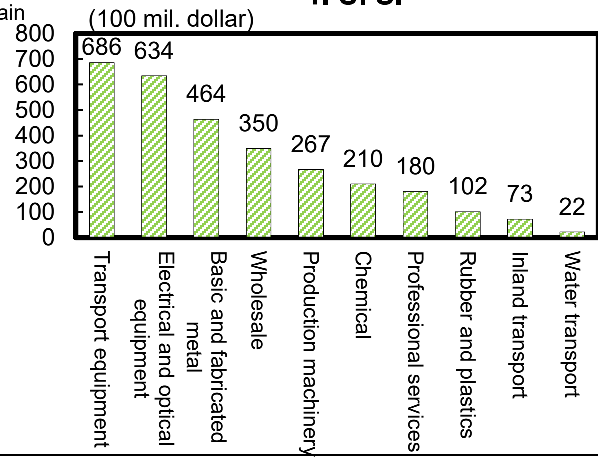
2. China



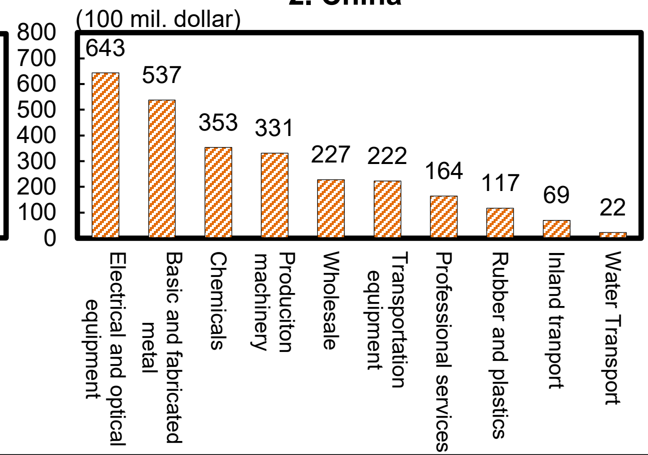
Japan's two-sided and pure-backward GVC participation rates have increased. The structure has shifted from supplying intermediate goods such as core components to other countries, to relocating the production bases of these goods to countries with lower production costs and using the intermediate inputs produced in these countries to produce goods and services. Meanwhile, China is proceeding the internalisation of its supply chains.

Figure 2: Production induced by final demand of the U.S. and China

1. U. S.

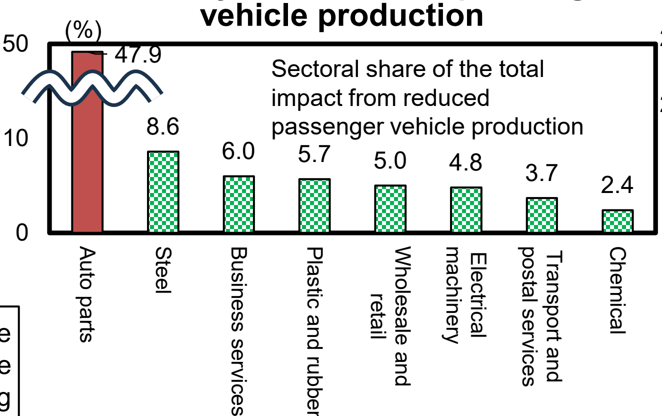


2. China



The impact of decline in demand in the U.S. and China could be broad across various sectors, including transportation equipment, electrical machinery, metal products, and wholesale.

Figure 3: Breakdown of industries affected by the decline in passenger vehicle production



The ripple effects of the decline in passenger vehicle production extend across a wide range of industries, including auto parts and steel.

Figure 4: Trade creation effects of free trade agreements

The conclusion of free trade agreements boosts trade between countries through trade creation effects.

(Sources) Asian Development Bank (ADB), Ministry of Internal Affairs and Communications, and the Centre for Economic Policy Research (CEPII). For details, refer to the main text (Figures 3-1-30, 32, 34, and 38).

3-2: Changes and Challenges of Japanese Firms (1)

Figure 1: Operating profit margin by capital size

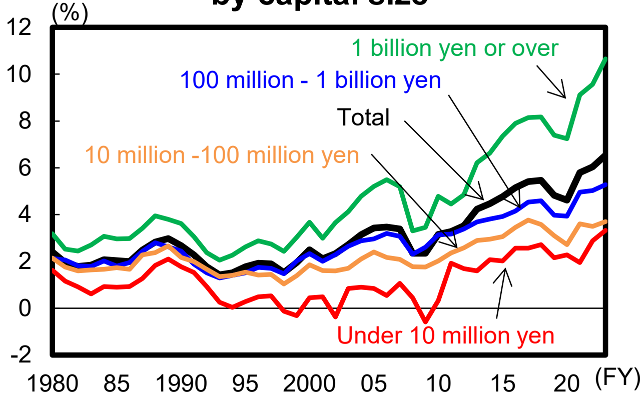


Figure 2: Disposition of pre-tax net Income

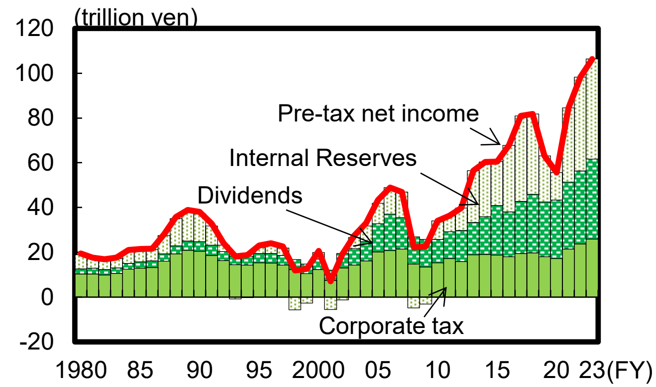
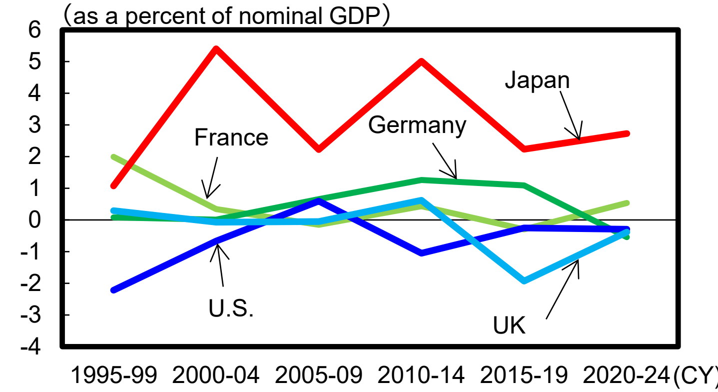


Figure 3: Cash surplus/deficit in non-financial firms



Operating profit margins have improved and reached record highs across firms of all capital size groups. However, a large portion of the increased profits has been retained as internal reserves.

The corporate sector in Japan has consistently recorded a financial surplus since the late 1990s, in contrast to other advanced economies.

Figure 4: Share of each asset to total assets

1. Large enterprises **2. SMEs**

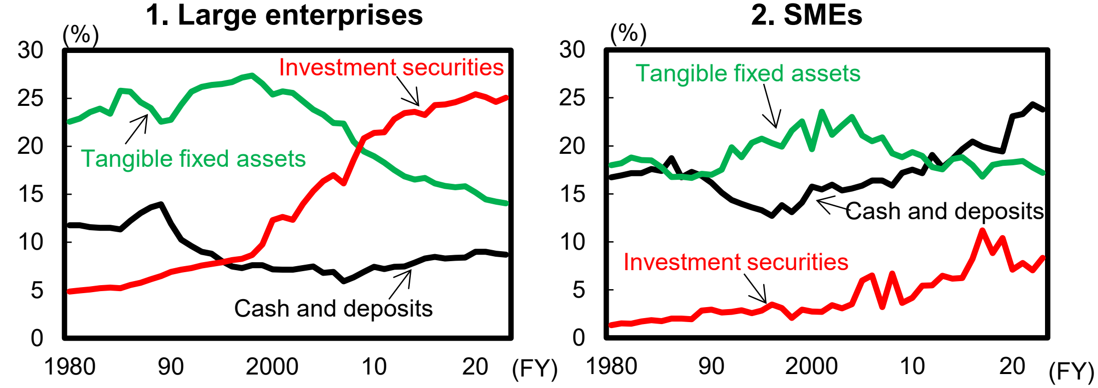
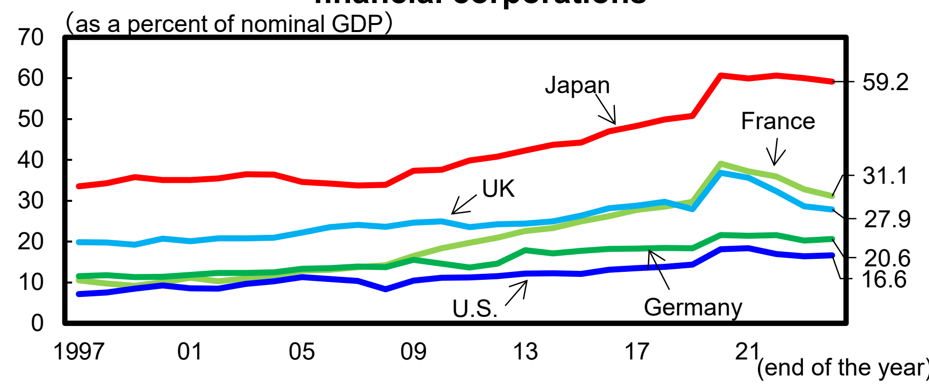


Figure 5: Cash and deposit asset balances of non-financial corporations



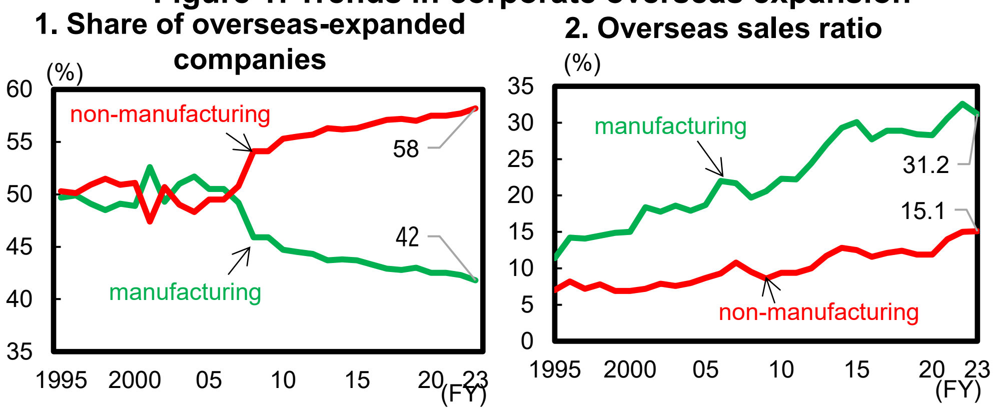
In large firms, the share of investment securities has increased significantly reflecting the establishment of overseas subsidiaries and M&A activities. In contrast, in small and medium-sized firms, the share of cash and deposits has increased significantly. In both cases, the share of fixed assets has declined.

The ratio of cash and deposits to GDP in Japan's corporate sector is exceptionally high, at around 60%, and has remained at a high level internationally.

(Sources) Ministry of Finance, Bank of Japan, Cabinet Office, and OECD. For details, refer to the main text (Figures 3-2-2, 4, 6, and 7).

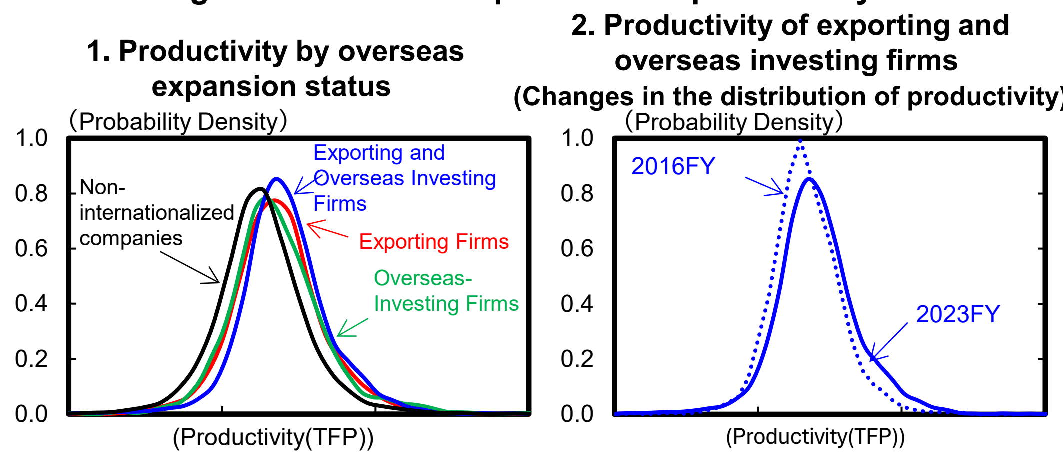
3-2: Changes and Challenges of Japanese Firms (2)

Figure 1: Trends in corporate overseas expansion



The share of non-manufacturing industries in Japanese overseas subsidiaries is increasing, including wholesale/retail and transportation.The ratio of overseas sales has also been steadily rising.

Figure 2: Overseas expansion and productivity



Firms that are expanding overseas tend to have relatively high productivity. While overall productivity has improved compared to pre-pandemic levels, variability in productivity among firms has widened.

Figure 3: Changes in productivity and wages by export status (start VS not start)

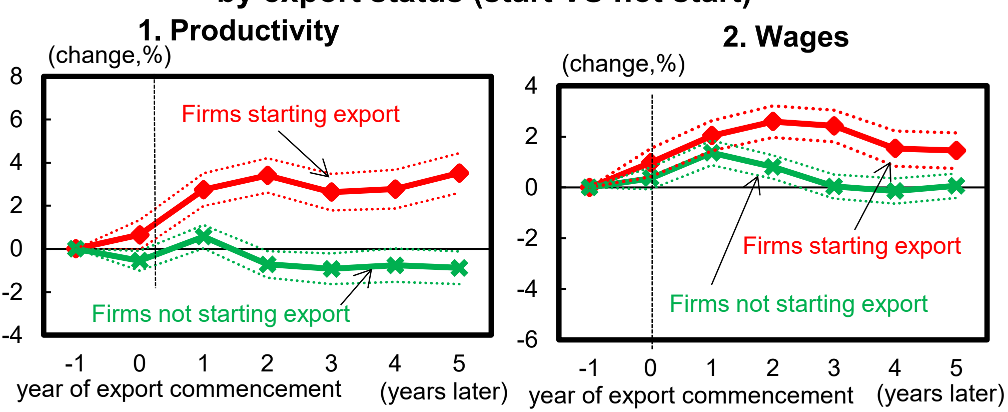
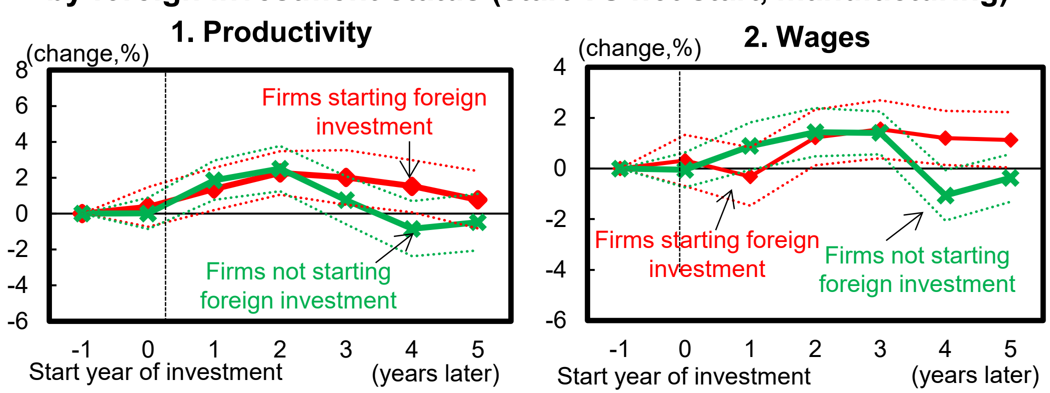


Figure 4: Changes in productivity and wages by foreign investment status (start VS not start, manufacturing)

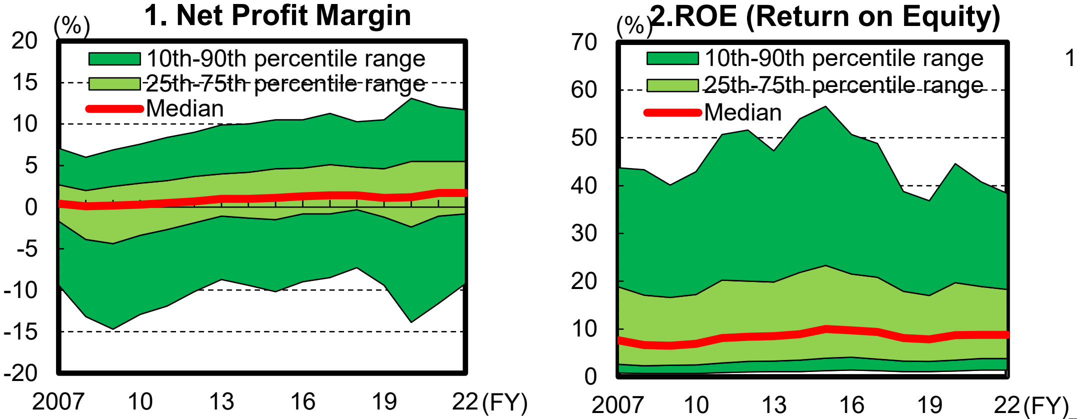


The initiation of exports in Japanese companies has contributed to improvements in both productivity and wages. In contrast, the initiation of overseas direct investment and financing has not necessarily resulted in clear improvement in productivity and wages in the manufacturing sector. It is important to create an environment where corporate funds are redirected toward domestic investment through measures such as regulatory reforms to improve the business environment.

(Sources) Ministry of Economy, Trade and Industry and Ministry of Finance. For details, refer to the main text (Figures 3-2-9, 13, 17, 18, 19, 20, and 21).

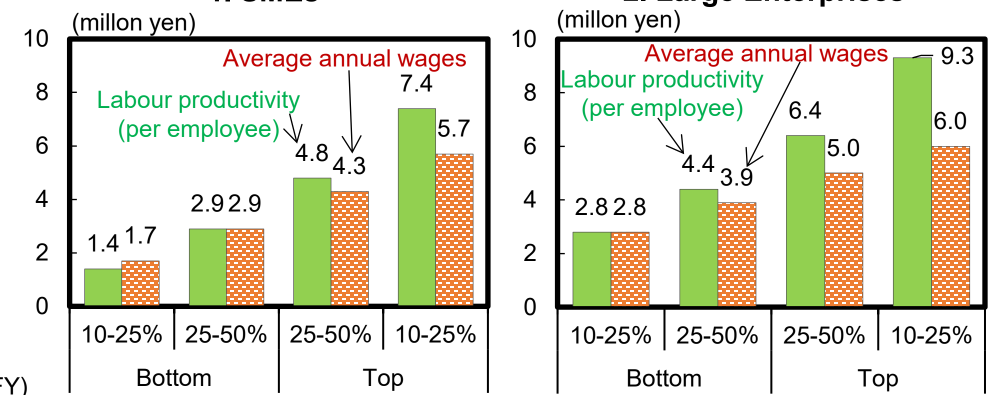
3-2: Changes and Challenges of Japanese Firms (3)

Figure 1: Distribution of profitability indicators for SMEs



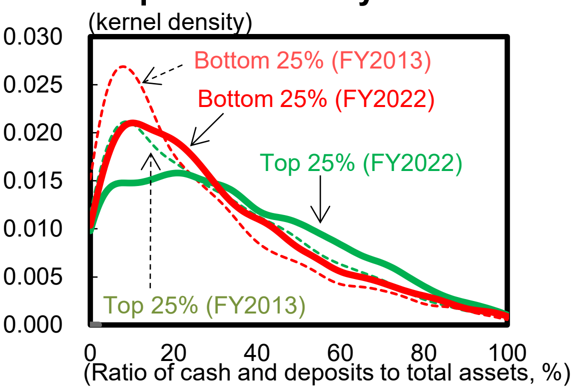
While the profit margins of high-profitability companies are on an upward trend, the ROE in high-ROE companies is on a downward trend. There is room for improvement in capital efficiency.

Figure 4. Comparison of labor productivity and wage levels



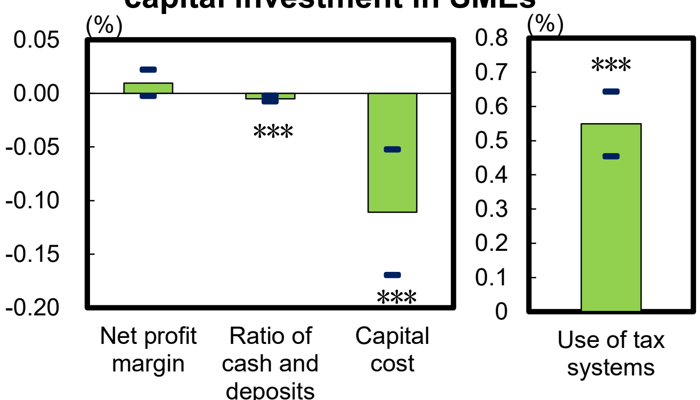
High-productivity SMEs have wage levels comparable to those of medium-sized and large firms. It is important to enhance productivity through promoting price pass-through and investment, and strengthen organizational foundations through business succession and M&A.

Figure 2: Distribution of cash and deposits ratios by ROE Rank



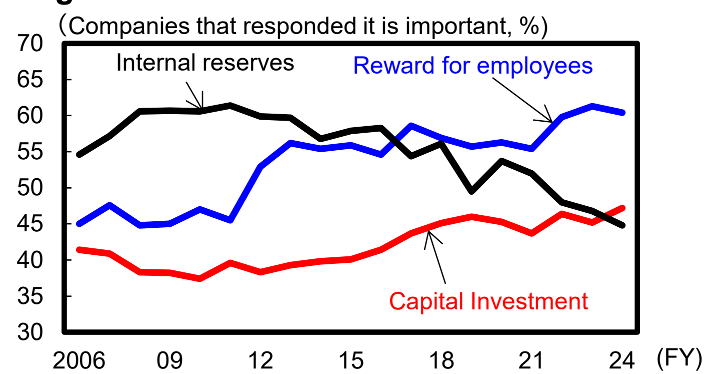
In companies with high ROE, the ratio of cash and deposits has increased over the past decade.

Figure 3: Factors affecting capital investment in SMEs



Firm's cash holdings do not result in capital investment. Tax incentives for promoting investment can play a role in proactive capital investment.

Figure 5: Profit allocation stance of SMEs



The priority of internal reserves in the profit allocation of SMEs is declining. It suggests an emerging shift.

(Sources) Small and Medium-sized Enterprise Agency, Ministry of Economy, Trade and Industry, Cabinet Office, and Ministry of Finance." For details, refer to the main text (Figures 3-2-24, 25, 29, 30, and 31).