

ECONOMIC RESEARCH – NOVEMBER 2025

INVESTMENT INSIGHT JAPAN



- ✓ Exacerbated dichotomy in sectoral PMIs
- ✓ Consumer confidence remains hesitant
- ✓ Inflation remains well above the BoJ's target
- ✓ Bank of Japan caught between forced normalization and recession risk

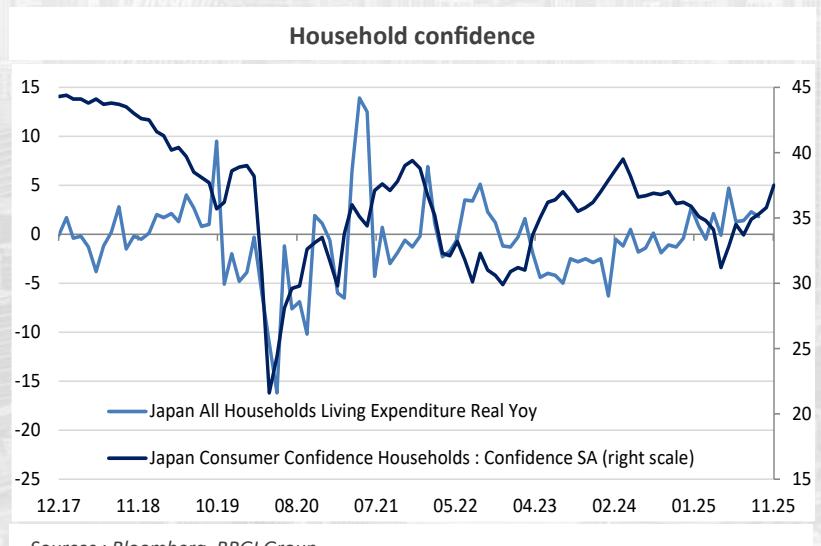
STAGFLATION RESHUFFLES THE DECKS FOR JAPANESE ASSETS

Structural divergence: The two-speed economy

November's PMI data confirms a deepening economic bifurcation. While the composite index remains resilient at 51.5, it masks a dangerous imbalance: the service sector (53.1) stands as the sole growth engine, while manufacturing remains stuck in contraction. This "two-speed" dynamic leaves the economy's momentum fragile, heavily reliant on services to offset industrial weakness.

Industrial resilience: A buffer against recession

Despite the pessimistic manufacturing PMI sentiment, hard data provides a more nuanced and potentially optimistic outlook. Industrial production defies the gloom, registering a year-on-year increase of +3.8% in September and a surprising month-on-month recovery of +1.4% in October—shattering consensus forecasts of a -0.6% contraction. This divergence between sentiment and output suggests that while manufacturers are pessimistic, actual activity is holding up. This "hard data" surprise is critical: it indicates that the Japanese economy is likely to avoid a technical recession in Q4, provided domestic demand can sustain its role as a counterweight to external weakness.



Consumer sentiment: Inflation erodes purchasing power

The anticipated consumption-led recovery faces headwinds from persistent inflation. While nominal wage growth remains robust, the "money illusion" is fading as real wage gains are negated by rising prices for everyday goods. The stagnation of private consumption in Q3 (+0.1%) signals the exhaustion of summer momentum. Although the divergence between spending and sentiment has narrowed, the Consumer Confidence Index remains low at 35.8, confirming that households do not yet perceive a tangible improvement in their financial conditions. However, looking toward the end of 2025, early indicators point to a potential recovery in retail sales, suggesting that the hesitancy may be temporary.

Inflationary persistence: Above target dynamics

Inflation continues to surprise to the upside, firmly entrenching itself above the Bank of Japan's target for three years running. The overall CPI has risen to +3.0% (Tokyo 2.8%), with the index excluding food and energy holding at +2.8%. A critical driver has been the shock in rice prices—up nearly 40% year-on-year—alongside rising electricity costs. Crucially, the nature of inflation is shifting: while external pressure on Producer Prices (PPI) has dissipated (stabilizing around 2.7%), Japan is now facing "homegrown" inflation driven by the services sector (+1.5%). This transition from imported to domestic inflation is a significant structural development being closely monitored by policymakers.

The BoJ's dilemma: Navigating stagflation risks

The combination of a Q3 GDP contraction and 3.0% inflation has radically altered the Bank of Japan's calculus, trapping the institution in a "stagflationary" dilemma. The central bank is effectively flying blind; the argument that inflation is merely "transitory" or "imported" is losing validity as the "core-core" index remains stuck above 2.5%. The widening interest rate differential with the US and Europe continues to weaken the yen, exacerbating the cost of energy and food imports. While orthodox policy would dictate an immediate rate hike to defend the currency, the fragility of the real economy makes this a high-risk gamble.

Policy outlook: Strategic status quo

The BoJ faces a choice between three high-risk scenarios: a hike that crushes consumption, a status quo that weakens the yen, or intervention without tightening. We assess that the BoJ will likely prioritize the protection of the fragile domestic recovery over immediate inflation fighting. Premature tightening would spike mortgage and SME financing costs, potentially turning a slowdown into a deep recession in 2026. Therefore, we expect the BoJ to maintain the status quo until spring, potentially coordinating with the Ministry of Finance for FX intervention if necessary. The central bank is gambling that the Shunto wage negotiations will eventually allow incomes to catch up with the new 3% inflation reality.

