Daiwa's Economic View

US/Japan tariff agreement ~ Implications of 15% reciprocal tariffs

- Agreement is positive surprise compared to our scenario
- Downward pressure halved compared to reciprocal tariffs of 25%?
- Economic, price outlooks may become neutral in BOJ's July *Outlook Report* following US/Japan tariff agreement
- Next BOJ rate hike now likely in Oct-Dec 2025

FICC Research Dept.

Kento Minami
81-3-5555-8789
kento.minami@daiwa.co.jp

Kenji Yamamoto
81-3-5555-8784
kenji.yamamoto@daiwa.co.jp

Daiwa Securities Co. Ltd.

US/Japan tariff talks: Rice market liberalization, investment in US help lower reciprocal tariffs to 15%

On 23 July (Japan time), US President Donald Trump announced that he had agreed to impose reciprocal tariffs of 15% on imports from Japan. The agreement came as a positive surprise, considering there were concerns that the negotiations could drag on following the ruling party's defeat in the Upper House election.

Even more surprising was the agreement to halve the additional sectoral tariff of 25%, or 12.5%, on automobiles, bringing the total rate to 15% when combined with the original US auto tariffs of 2.5%. Even though we had believed that reciprocal tariffs could be reduced to 15-20%, we considered it difficult to achieve a reduction in automobile tariffs due to Trump's strong stance on that issue.

The Japanese side seems to have indicated its intention to open up its market to automobiles and agricultural products, such as rice, in addition to investing $550bn in the US, as a bargaining chip when negotiations with the US. Describing the agreement, Trump said, "We just completed a massive deal with Japan, perhaps the largest deal ever made."

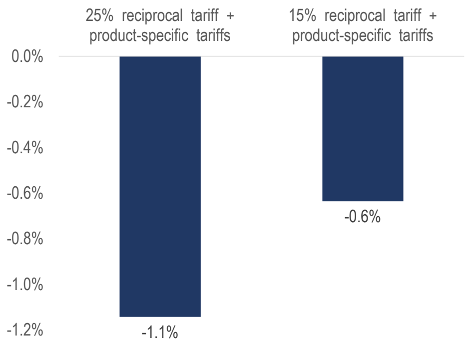
The reduction of reciprocal tariffs announced since July 7, from 25% to 15%, and the reduction of additional sectoral tariffs on automobiles, which are considered to have a significant impact on the Japanese economy, to 12.5%, can be viewed as a favorable result for the Japanese economy.

Impact on the Japanese economy: Roughly 0.6ppt drag on real GDP?

In addition to reciprocal tariffs of 15%, if the already in effect 50% tariffs on steel and aluminum remain in place, along with the sectoral 12.5% tariff on automobiles, as well as the additional 12.5% sectoral tariff on pharmaceuticals and semiconductors, the total impact on Japan's real GDP is estimated to be a cumulative drag of about 0.6ppt vs the case in which no additional tariffs are imposed. That said, if reciprocal tariffs of 25% had remained in place and if the sectoral 25% tariff on automobiles was not lowered, there could have been a cumulative drag of roughly 1.1ppt on Japan's real GDP. Based on this agreement, the impact of tariffs can be considered to have been reduced by almost half.

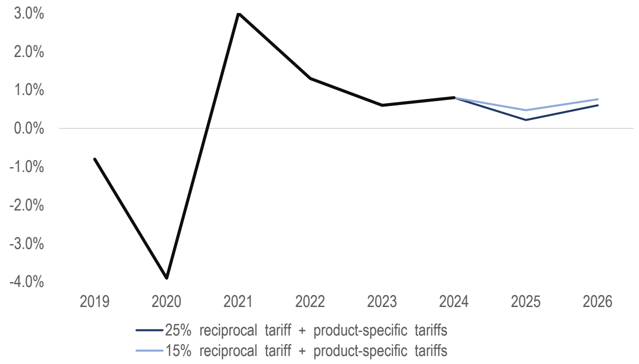
With this tariff agreement in place, it is now possible that the FY25 real GDP growth rate will remain within its potential growth rate.

Impact of Tariff Policy on Japan's Real GDP



Source: Compiled by Daiwa.
Note: Regarding additional product-specific tariffs in the case of 25% reciprocal tariff, our simulation assumes (1) 50% on steel and aluminum and (2) 25% on autos, auto parts, semiconductors, and pharmaceuticals.

Our Forecasts for Real GDP Annual Growth Rate



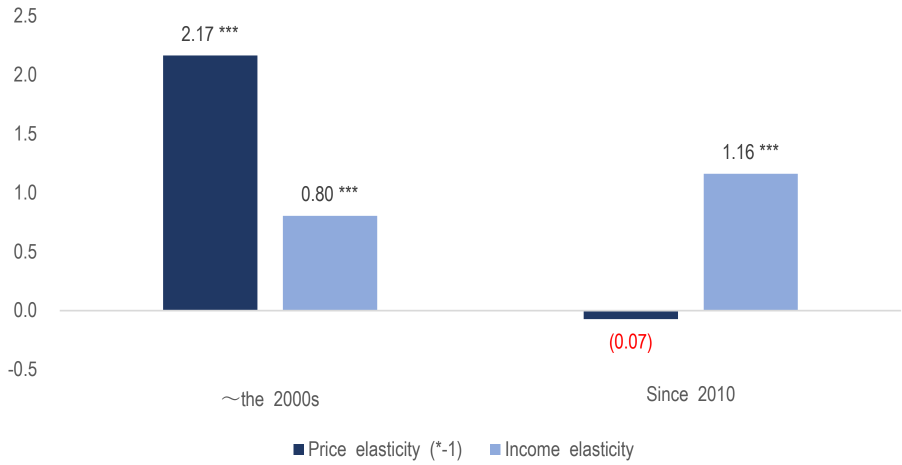
Source: Compiled by Daiwa.

That said, the above-mentioned figures are estimates based on the assumption that the price elasticity of export quantities is 1. Price elasticity is an indicator that shows how much the quantity of exported goods changes when the price of exports fluctuates. Price elasticity of 1 means that if the price increases by 15%, demand will also decrease by 15%.

This price elasticity may have declined in recent years. If this assumption is correct, the impact on export volumes could be limited even if Japan passes on tariff costs to prices. The actual impact on the Japanese economy may be smaller than the above-mentioned estimates.

Actually, looking at current macroeconomic indicators, the impact on the real economy, such as Japanese exports and production, has not yet become apparent. Also, the US/Japan tariff agreement is expected to alleviate uncertainty among companies and consumers to a certain extent, thereby limiting the impact on spending (such as capex and consumption).

Price/Income Elasticity of Exports to US



Source: MOF, BOJ, US BEA; compiled by Daiwa.
Note: Three stars indicate statistical significance at the 1% level, and for convenience, we multiply a price elasticity by –1.

Monetary policy implications

The assumption of 15% reciprocal tariffs is close to the image presented by Governor Kazuo Ueda during his 1 May post-meeting press conference when he said, "Rather than assuming that the result of tariff negotiations will be zero or only 10%, assume that the result will settle at a slightly higher level." This is viewed as consistent with the BOJ's on-track tariff assumptions as of May.

Also, a 22 July media report citing related parties said that the BOJ believes that even if a 25% tariff were imposed on Japan, that would not significantly lower Japan's real GDP below its potential growth rate. This expressed the Bank's recognition that even with reciprocal tariffs of 25%, its policy of hiking interest rates would not be hindered. Furthermore, these reports suggest that the BOJ, "Fully anticipated the possibility of 25% reciprocal tariffs." As such, in addition to the reduction of reciprocal tariffs to 15%, the reduction of additional sectoral tariffs on automobiles to 12.5% can be considered a positive surprise for the BOJ.

We identified the following two conditions for the BOJ's next interest rate hike: (1) neutralization of economic and price risk balance (= reduced tariff uncertainty) and (2) assessment of tariff impacts on the Japanese economy and prices.

An 18 July Reuters article (in English) citing relevant parties reported that "Such data (showing no apparent impact of tariffs at present) may be reflected in the next report (*Outlook Report*)'s language on the economic outlook and risks, as well as in the board's growth projections." Also, given the current situation in which tariff uncertainty has decreased as a result of the recent US/Japan tariff agreement, there is a strong possibility that the risk balance for the economy and prices will become neutral in the next *Outlook Report*.

However, at this juncture there are only rough estimates for the tariff impacts. It will be difficult for the BOJ to immediately raise interest rates because it needs to first carefully assess the impact of tariff policies in light of the recent US/Japan negotiations. However, from an economic perspective, after carefully confirming corporate trends in the BOJ's Tankan survey due out during the Oct-Dec 2025 period (1 Oct and 15 Dec), as well as the BOJ branch managers' meeting report in mid-October, we believe that conditions are in place for an interest rate hike without waiting for the outcome of next year's annual spring labor-management wage negotiations.

Furthermore, prices are rising more sharply than expected. Given the situation in which the relationship of "tariff negotiation progress ≈ interest rate hikes" is becoming established, as pointed out on 22 July by our Chief Strategist Eiichiro Tani, there is the possibility that an interest rate hike within the year will be taken into consideration at the July meeting, with the increase in positive factors, although uncertainty remains.

Based on the above considerations, we now forecast the next interest rate hike to be implemented in the Oct-Dec 2025 quarter (previously Jan-Mar 2026 quarter).

IMPORTANT DISCLOSURES

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Ratings
Issues are rated 1, 2, 3, 4, or 5 as follows:
1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

Target Prices
Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

Disclosures related to Daiwa Securities
Please refer to https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings
This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at: https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/credit_ratings.pdf. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law
(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)
If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association, Japan Security Token Offering Association