

# Daiwa's Economic View

## BOJ likely to hike rates within this year ~ How long will rate-hiking pause last?

- US/Japan trade agreement to reduce Japan's downside risks through two pathways: (1) increased likelihood of soft landing for US economy and (2) sustainability of Japan's export competitiveness
- BOJ sees underlying inflation approaching 2%
- Amidst "clearing fog," BOJ ensuring "discretion" to hike rates as early as this autumn
- Once "scheduled suspension" ends, (rate-hiking) train will resume cruising speed

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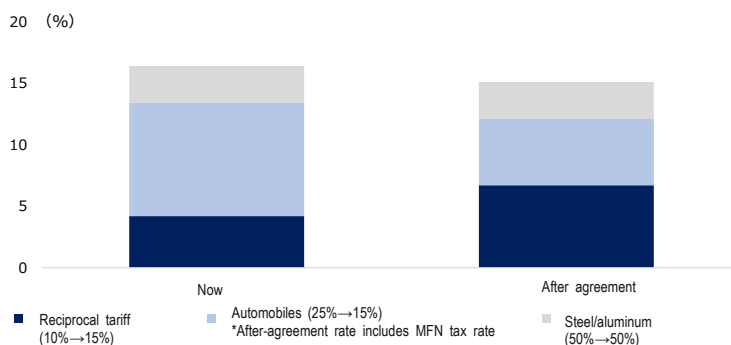
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## Success of US/Japan trade agreement to create momentum for other agreements

Last week, the Trump administration [concluded](#) an important trade agreement with Japan that opens up new possibilities for future trade negotiations. The US administration also signed agreements with the Philippines and Indonesia, similar to those with other ASEAN countries. The most notable point from the US/Japan agreement is that the two governments agreed to reduce the 25% tariff on automobiles, which had been a major point of contention in negotiations between Japan and the US. The Trump administration's demonstration of its willingness to compromise on sector-specific tariffs is a positive sign for other countries and regions where such tariffs are a major issue.

### US Effective Tariff Rates on Japan



Source: US Department of Commerce, White House; compiled by Daiwa.

South Korea, which is in a similar position to Japan, will likely demand the same 15% tariff rate as Japan for both reciprocal tariffs and automobile tariffs. However, if it also strongly demands tariff reductions on steel and aluminum, which account for approximately 11% of its total exports to the US, the hurdle to reaching an agreement could become higher.

Also, the US agreements with the Philippines and Indonesia are each consistent at 19% and, considering that the US administration is seeking to prevent re-shipments "third-party exports" from China, this further strengthens the view that the same tariff rate is the "landing point" for other ASEAN countries.

In addition, the media had reported that the EU and the US are nearing the conclusion of a trade agreement. Indeed, US President Donald Trump and European Commission President Ursula von der Leyen met on 27 July and did in fact agree to impose a 15% tariff on EU products imported into the US, including automobiles. The agreement includes the EU investing \$600bn in the US, purchasing US military equipment, and agreeing to purchase \$750bn worth of energy products.

This agreement is similar to the agreement with Japan and will also apply to automobile imports, which are currently subject to a 27.5% tariff. As such, Germany appears to have pushed ahead with the agreement, even overcoming resistance from other EU countries.

As a result, ahead of the 1 August deadline, reciprocal tariffs of 30% for the EU, as suggested by the Trump administration, have been avoided. The success of Japan and the EU this time will generate momentum for other agreements. In the case of US/Japan and US/EU agreements, automobile tariffs were reduced, but reciprocal tariffs were also set at 15%. As such, the overall US average tariff rate will not be significantly impacted. In particular, the avoidance of a rapid escalation with the EU is clearly a positive for the US and the global economy, as well as for the BOJ. The immediate focus is on the extent to which agreements with other major trading partners, such as South Korea, India, Canada, and Mexico, which are important for the future of the global economy, will be finalized by the deadline.

Of course, we cannot rule out that Trump will further strengthen his stance on punishing countries that fail to reach an agreement by 1 August. However, according to the latest data compiled by MOF, the actual effective tariff rate (dynamic basis) of the US as of June was less than 10%, significantly lower than the estimated 15% on a static basis. This is partly due to increased imports from Mexico and Canada in accordance with the USMCA, as well as a sharp decline in imports from China. However, apparently the impact on the US and global economies has ultimately been mitigated.

### **US/Japan agreement to reduce downside risks for Japan via two pathways**

The recent agreement between Japan and the US clearly removes downside risks for both countries. From Japan's perspective, the main macroeconomic issue is tariffs on Japanese car and auto parts exports to the US. Here, the reduction in sector-specific tariffs (to 15%) is much more important for Japan than the 15% reciprocal tariff.

This is also strengthening the BOJ's sense of getting back on track via two pathways. First, as mentioned above, trade negotiations are progressing for Japan and other countries/regions, reducing the likelihood of a sharp rise in the average effective tariff rate in the US. This is further reducing the likelihood of inflation and economic recession in the US.

[As mentioned before](#), what is now critically important for Japan's exporting industries, which have become highly value-added, is not so much the level of prices, including tariffs (price elasticity), but rather the economic trends in the US, which is the final demand country for their products (income elasticity). BOJ Policy Board member Hajime Takata expressed a similar view in his speech on 3 July. The increasing likelihood of a soft landing in the US should also have a positive impact on the BOJ's outlook regarding the tariff shock.

#### ◆ **BOJ Policy Board member Hajime Takata (3 Jul 2025)**

- By contrast, unlike the trade friction until the 1990s, recent U.S. tariff policy targets a wide range of countries and regions, so that Japan is not the only one affected. Moreover, as a result of Japan's industrial advances over around three decades, **some industries -- such as automobiles, semiconductors, and basic materials, including steel and chemicals -- have seen an increase in the weight of products for which alternate production is limited within the United States. In this situation, the price elasticity for their products may have declined.**
- Therefore, it will likely be easier for Japanese firms to pass on the recent tariff hikes to selling prices than it was in the past. Although the imposition of tariffs will inevitably have an impact in the form of lower demand, the extent of the impact is unlikely to be greater than what Japan went through in the 1990s. In addition, if tax cuts and other fiscal policy measures are implemented in the United States, depending on their specifics, an increase in U.S. consumers'

purchasing power could, combined with the impact from improved asset prices, drive recovery in the sales volume from S1 to S0 by shifting the demand curve upward, as shown in Chart 21. Thus, **the impact on Japan's economy, particularly corporate profits, will likely be limited, at least compared with the period of trade friction around 1990. In this context, the tariff policy is unlikely to bring about the kind of corporate behavior that leads to a shrinking equilibrium, such as restraining wages, which was once common in Japan.**

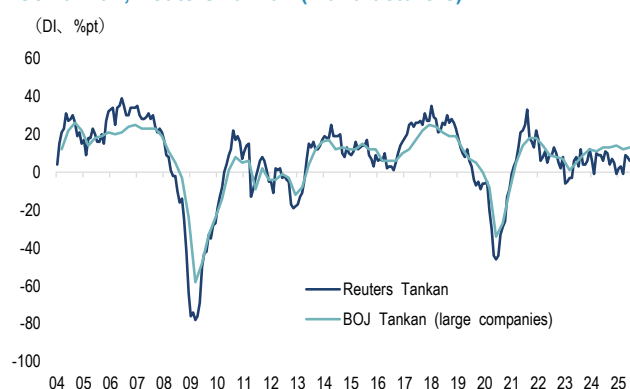
Second, the US/Japan agreement entails some positive aspects for Japan in terms of competitiveness with other countries and regions. In other words, the 15% reciprocal tariff rate on Japan is lower than that of other Asian countries that have recently concluded trade agreements (Indonesia, Philippines, Vietnam), making it more likely that Japan's effective tariff rate will be lower than that of other manufacturing countries. Also, the reduction in sector-specific tariffs on Japanese automobiles may have actually increased Japan's competitiveness. Still, that will depend on future developments involving tariff rates for South Korea and other countries.

If higher tariffs were imposed on Japan, as compared to those for other countries, that would have posed a significant risk in terms of increased vulnerability for Japan. However, that likelihood has declined and, as such, downside risks for the BOJ's outlooks have been further reduced. Also, the main issue for Japan is sector-specific tariffs on automobiles, metals, and (in the future) semiconductors. However, this time, if the US imposes sector-specific tariffs on semiconductors and pharmaceuticals, the lowest tariff rate among all countries will be applied to Japan. The significance of that agreement for Japan is enormous.

### US/Japan trade agreement bolsters likelihood BOJ hike rates within this year

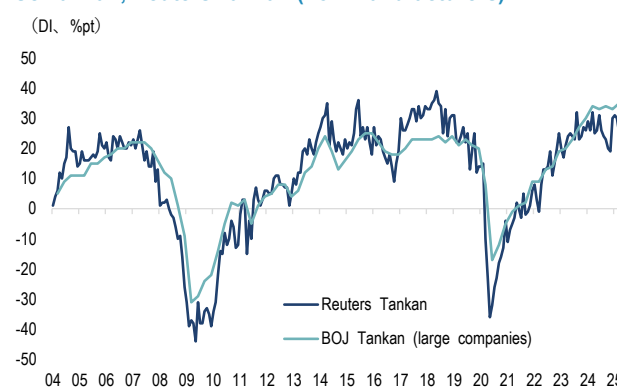
The conclusion of the US/Japan trade agreement, which was more positive than expected, has reduced uncertainty and downside risks for the Japanese economy. That in turn, has strengthened prospects for the BOJ to make an interest rate hike within this year. At the end of last week, several media outlets reported that multiple BOJ officials had discussed similar views. Examples include a Bloomberg report ("Following the agreement reached in the US/Japan tariff talks, conditions could be in place for an interest rate hike within this year, depending on corporate behavior.") and a Reuters report ("Following the conclusion of the US/Japan tariff negotiations, the BOJ will be in a position to raise interest rates by the end of the year after assessing the progress and impact of negotiations in various countries based on data and other information.") However, these reports simply confirm [our recognition](#) of the situation and so are nothing new.

BOJ Tankan, Reuters Tankan (manufacturers)



Source: BOJ, Reuters; compiled by Daiwa.

BOJ Tankan, Reuters Tankan (non-manufacturers)



Source: BOJ, Reuters; compiled by Daiwa.

On 26 July, the *Asahi Shimbun* ran an article titled "BOJ unlikely hike rate at next meeting; expect upward revision for inflation outlook." According to this article, parties within the BOJ have said, "Tariffs on Japanese exports, including automobiles, have been reduced, which suggests a more positive outlook compared to the Bank's previous outlook." Likewise, the *Nikkei* also reported on 27 July that BOJ officials said that compared to its April *Outlook Report*, the current situation is **"becoming clearer."**

As trade negotiations with the US pose a significant risk to Japan's outlook, the BOJ has accordingly maintained a wait-and-see stance while monitoring whether or not substantial bilateral trade agreements can be concluded. This was also stipulated in the risk balance statement in the April *Outlook Report*, which stated that "risks are skewed to the downside."

In other words, the BOJ has formed a time frame for raising real interest rates based on its assessment that the "risk balance for economic activity and prices is skewed to the downside." In this manner the Bank justified its policy stance as "There is high uncertainty with downside risks surrounding trade policies. Given this, the Bank should, at this point, maintain accommodative financial conditions with the current interest rate level and thereby firmly support the economy" (June Summary of Opinions).

However, as we surmised, [amid the "higher-than-expected prices" \(BOJ\), moving the risk balance statement to neutral, could be viewed as a step forward toward raising interest rates](#). Reuters also reported that, "In its previous *Outlook Report*, the BOJ stated that the outlook for prices in fiscal 2025 and 2026 is more likely to be on the lower side." However, [this time the risk balance wording may change](#). Some Policy Board members have expressed opinions in favor of "revising upward the price outlook for FY26" (*Nikkei*).

### Focus on timing, conditions for resuming rate hikes process (return to neutral)

Currently, there is a certain commonality between the BOJ and the Fed as they are both "pausing" their policy stance under the process of returning to neutral. Fed Chairman Jerome Powell stated, "We would have already lowered interest rates if not for the tariff measures." This means that the Fed is in the process of returning interest rates to neutral, but has presented its view that this process has been "interrupted" by the threat of tariff inflation.

Similarly, the BOJ's Takata stated in his abovementioned speech that "I believe that the Bank is currently only pausing its policy interest rate hike cycle and should continue to make a gear shift after a certain period of "wait and see." Even though the vectors are different (rate cut by Fed, rate hike by BOJ), they are similar to a public transportation "temporary suspension" or a "scheduled suspension" (in the words of Takata).

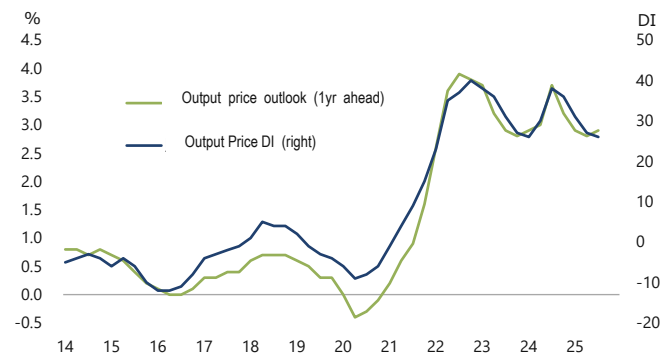
#### ◆ BOJ Policy Board member Hajime Takata (3 Jul 2025)

- In a sense, [this approach is similar to a 'scheduled suspension' for public transportation services. Anticipating a sort of 'reciprocal tariff typhoon,' forecasts have been lowered in advance](#). In that sense, if these preliminary assumptions change, or if the weather forecast for the 'reciprocal tariff typhoon' is altered in some way, the economic outlook will naturally change as well. Accordingly, we want to keep a close eye on developments in that area going forward.

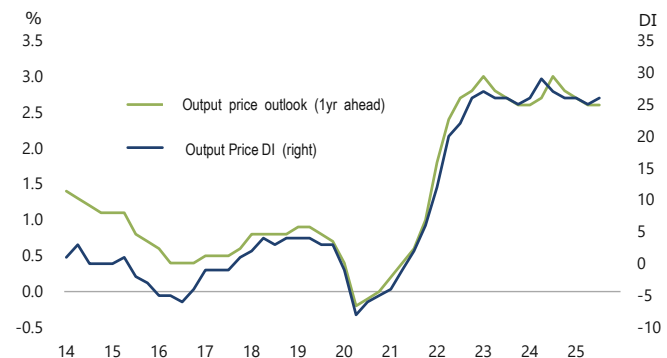
In other words, the key focus going forward will be the timing and requirements for resuming the rate hike process (i.e., returning to a neutral level). In that respect, at the Sintra Forum on July 1, BOJ Governor Kazuo Ueda cited three main points as factors in producing the outlook: [\(1\) underlying inflation rising moderately alongside wages, \(2\) the impact from higher tariffs, which is currently unclear, and \(3\) supply shocks mainly related to food, which are expected to ease towards the end of the year](#).

It is very significant that BOJ Deputy Governor Shinichi Uchida explicitly stated in his press conference last week that the likelihood of achieving the outlook was increasing in line with the decline in uncertainty, and that, for now, there had been no change to the baseline scenario that wage increases would continue. According to Reuters, with inflation indicators rising since May, there are those at the BOJ who think underlying inflation has come closer to reaching 2%.

Thanks to the recent US/Japan agreement, the BOJ is likely to judge that we will see sustained momentum for continued wage hikes and corporate sentiment regarding winter bonuses and wage hikes during the 2026 spring wage negotiations, given the structurally tight labor market, which will support real household consumption going forward.

**Companies' Outlook for Output Prices (1yr ahead), Output Price DI (manufacturers of all sizes)**


Source: BOJ; compiled by Daiwa.

**Companies' Outlook for Output Prices (1yr ahead), Output Price DI (non-manufacturers of all sizes)**


Source: BOJ; compiled by Daiwa.

### Securing discretionary leeway to implement rate hikes as early as autumn

Personally, I interpreted last week's press conference by BOJ Deputy Governor Uchida as implying that the BOJ was securing discretionary leeway to monitor developments regarding the impact from tariffs during the summer before implementing rate hikes as early as autumn, provided no new negative factors emerge. This interpretation is justified according to media reports based on sources from those in the know within the BOJ, such as a Reuters report stating that some think that it would be possible to implement a rate hike if the BOJ could confirm scenarios for achieving the outlook after checking hard data on the effects of tariffs, and a Bloomberg report stating that the BOJ was now more likely to make an early policy decision based on hearing surveys and data compared to before, when there was uncertainty about tariff policies due to prolonged negotiations.

Based on this, we anticipate that the next rate hike will take place in the Oct-Dec quarter. (The soonest would be when the October Outlook Report is released.) The risk is an earlier hike. Considering that *Yomiuri Shimbun* reported on 26 July that (a BOJ official) said that a decision about rate hikes should be made after confirming the impact on Japanese corporate earnings from tariffs, we forecast that the earliest timing would be in October. Going forward, the market is likely to watch closely to see whether, for the moment, the September policy meeting will be a "live" meeting, or eliminated.

As previously noted, in US/Japan trade negotiations, the JPY exchange rate may be "endogenous" for the BOJ's policy. The BOJ seems to be receiving the implicit reward of implementing rate hikes justified by domestic conditions in exchange for improvement in the fundamental outlook thanks to the trade agreement.

### ◆ Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States (5 Jun 2025)

- **BOJ policy tightening should continue to proceed in response to domestic economic fundamentals including growth and inflation**, supporting a normalization of the yen's weakness against the dollar and a much-needed structural rebalancing of bilateral trade.

In other words, if we interpret the current BOJ phase as a "temporary pause" (suspension of rate hikes) in the rate hike process on the way back to neutrality, as underlying inflation approaches 2%, the market will likely sense that a rate hike to 1% (after a hike to 0.75%) will come relatively soon. Put another way, once the planned suspension of train operations is over, the trains will resume operations at their fixed cruising speed.

At Sintra, BOJ Governor Ueda also mentioned that the BOJ's current policy interest rate was below the neutral level, while saying that the range of neutral interest rate estimated by the BOJ was very wide. Given the persistence (stickiness) of domestic inflation and the outlook for the US economy in 2026, we think that market pricing in of rate hikes may be too dovish. Naturally, the level of the neutral rate (= terminal rate) will likely become a topic of discussion again together with the resumption of rate hikes.

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