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Daiwa's View

What are the potential obstacles to BOJ raising rates in 2025?

- BOJ views autumn as the earliest timing for rate hike
- A rate hike would require that mechanism in which wages and prices influence each other positively continued uninterrupted
- Potential obstacles to BOJ raising rates within the year: (1) greater-than-expected deterioration in corporate business conditions from this autumn onwards, (2) extreme political instability, and (3) aggressive rate cuts by Fed due to concerns about softening of US labor market

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Fog is unlikely to clear up all at once

As widely expected, the BOJ maintained its policy interest rate at 0.5% at the July Monetary Policy Meeting (MPM), while making an upward revision to its inflation outlook and risk balance to prices. The *Outlook for Economic Activity and Prices* report (*Outlook Report*) noted, "There have been positive developments in trade and other policies, such as negotiations between Japan and the United States resulting in an agreement." It described the uncertainty regarding future economic activity and prices as high, albeit softening the wording from the "extremely high" used in the previous report. The report also touched on upside risks, such as "the possibility that developments such as recent moves toward fiscal expansion, particularly in the United States and Europe, could push up the global economy."

In his post-meeting press conference, BOJ Governor Kazuo Ueda described the US/Japan tariff agreement as a big step forward that would lead to reduced uncertainty surrounding the Japanese economy. However, he also said that it was still unclear where and how the impacts would appear, and that the fog was unlikely to clear up all at once, indicating a cautious stance of carefully watching future economic indicators.

Governor Ueda also downplayed the risk of falling behind the curve on inflation, stating that the upward revision to the FY25 price projection was mostly attributed to food, and that the BOJ did not believe that monetary policy was influenced by that. As such, he opposed the idea that a rate hike was appropriate to cope with short-term external cost-push inflation, which appears to have been perceived as dovish by the market[1].

Likelihood of achieving the outlook has increased slightly

The July *Outlook Report* maintained the previous view that the "underlying CPI inflation is likely to be sluggish, mainly due to the deceleration in the economy." As for the conduct of monetary policy, the report stated that "the Bank, in accordance with improvement in economic activity and prices, will continue to raise the policy interest rate." Given these statements, some appear to feel that a rate hike would be challenging.

However, Governor Ueda explicitly stated in his press conference that underlying inflation was rising slightly, as it had not yet stalled due to the impact of tariffs. He also said that the BOJ would make a decision on future monetary policy based on whether the likelihood of the projected path improved, and would not wait for underlying inflation to take hold. When asked about changes from the previous *Outlook Report*, he said that there was no significant change in the baseline projections, but added that confidence in achieving the projections had increased slightly.

[1] In the first place, it would be unlikely for a central bank governor to answer a question like this by saying that the risk of falling behind the curve was high.

The BOJ's stance of raising rates in accordance with an increased likelihood of achieving the outlook or greater confidence in projections (as Governor Ueda put it) remains unchanged. Therefore, if the likelihood of achieving the outlook has increased even slightly, it would be reasonable to interpret this as a step closer to a rate hike.

A rate hike would require that mechanism in which wages and prices influence each other positively continued uninterrupted

Governor Ueda deliberately avoided specifying the timing or conditions for the next rate hike. He indicated his intention to review data in the lead up to the next hike, and, notably, stated that the BOJ wanted to confirm whether the mechanism in which wages and prices influence each other positively continued uninterrupted.

The BOJ seems to forecast that (1) economic activity will soften in 2H 2025 (as expected) due to the combination of solid corporate sentiment (as seen in recent Tankan surveys) and the structurally tight labor market, and that (2), consequently, wage increases will continue, although not at the remarkable level seen in the 2025 spring wage negotiations.

In other words, rather than meaning that the data would need to show surprises on the upside, the wording "uninterrupted" implies that the BOJ would be OK if the uncertainty ("fog") with regard to the outlook diminished (cleared up) due to the impact from tariffs on economic activity and corporate sentiment not being worse than the BOJ's baseline "soft patch" scenario.

Raising wages properly in spring wage negotiations is becoming the norm

Although the press conference was regarded as dovish, Governor Ueda mentioned that the trend with solid wage hikes in spring wage negotiations had continued for several years and was becoming the norm, and that this warranted attention, and that, with the underlying inflation rate approaching 2% and inflation expectations rising to some extent, it was necessary to pay closer attention to the possibility that the headline CPI might impact core inflation and inflation expectations. These comments at least did not seem to have a dovish nuance.

◆ **July BOJ *Outlook Report* (31 Jul 2025)**

- As recent price rises are also somewhat attributable to the pass-through of increased personnel expenses and distribution costs to selling prices, it is possible that the price rises will persist for longer than expected, depending on firms' wage- and price-setting behavior. Since consumers purchase food items on a frequent basis, if the price rises persist, attention is warranted on the possibility that this may induce second-round effects on underlying CPI inflation through changes in household sentiment and inflation expectations.

In other words, given the current price situation, we are entering a phase in which it is increasingly important to consider the risk that the BOJ's main scenario (that the underlying inflation rate will stall temporarily) may not materialize. Governor Ueda's statement that the BOJ wanted to make policy decisions while taking such possibilities into account points to the risk-management approach mentioned by Deputy Governor Shinichi Uchida. This approach does not simply justify waiting blindly; rather, it calls for adjusting "monetary policy to best balance the upside and downside risks from the perspective of maintaining stability in economic activity and prices[2]."

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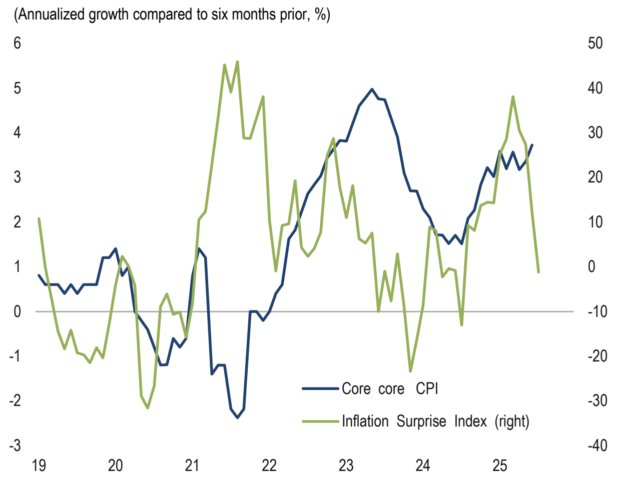
[2] At his post–July FOMC press conference, Fed Chair Powell also stated that policy would be determined based on "the evolving balance of risks."

Core Core CPI and Inflation Surprise Index in Japan



Source: Ministry of Internal Affairs and Communications, Bloomberg; compiled by Daiwa.

The current BOJ monetary policy stance is accommodative (with real interest rates at very low levels). Furthermore, given that the risk balance to prices has shifted towards a neutral direction compared to the previous outlook, we think that it is natural that the BOJ's "neutral position" would change from the standpoint of risk management.

The next rate hike is expected at the October meeting at the soonest

According to an urgent economist survey by Bloomberg after the July MPM, 42% of respondents anticipated that the next rate hike would be in October (which was the highest percentage), while 76% believed that the tariff agreement raised the possibility of a rate hike within the year. Before the July meeting, 36% (the highest percentage) had expected a hike in January 2026, which we found surprising. Now, many economists appear to be properly interpreting the July *Outlook Report* and the BOJ's policy reaction functions. The percentage of economists expecting a rate hike within the year rose from 42% to 53%.

After the July MPM, *Nikkei* also reported that the earliest timing for a rate hike was seen as autumn at the BOJ, and it noted that data and information on corporate earnings, capex, and price/wage settings would be gathered through the Tankan survey and the branch managers' meeting in October, and that BOJ officials said that they wanted to see the Tankan and reports at the branch managers' meeting. We find nothing at all unusual about projections of a rate hike as early as October.

Potential obstacles to BOJ raising rates in 2025 (1): Corporate business conditions turning out weaker than expected from this autumn onwards

If the fog clears and new data arrives, the BOJ is likely to gain enough confidence in wage prospects to raise rates this year (as early as October). If anything, the question going forward will be what could prevent a rate hike from being implemented within the year.

Of course, if the impact from tariffs were greater than expected and raised the risk to wages, and if the BOJ determined that that raised concerns about winter bonuses or 2026 spring wage negotiations failing, the Bank might refrain from raising rates and wait until the outcome of spring wage negotiations was almost certain (i.e., between January and March 2026).

On 1 August, the *Mainichi Shimbun* reported that a BOJ official cautioned that it would not be surprising if weaker-than-expected data (on corporate business conditions and other data) appeared from this autumn onwards. While the author personally feels that such concerns are unfounded, we will have to check the situation with the next Tankan survey and the branch managers' meeting.

Potential obstacles to BOJ raising rates in 2025 (2): Extreme political instability

Generally, it is easy to see how domestic political uncertainty could constitute an obstacle to the BOJ raising rates. That said, unless we see a stock market crash due to extreme political turmoil—such as a split in the ruling Liberal Democratic Party—political uncertainty is unlikely to act as a major constraint on the BOJ raising rates.

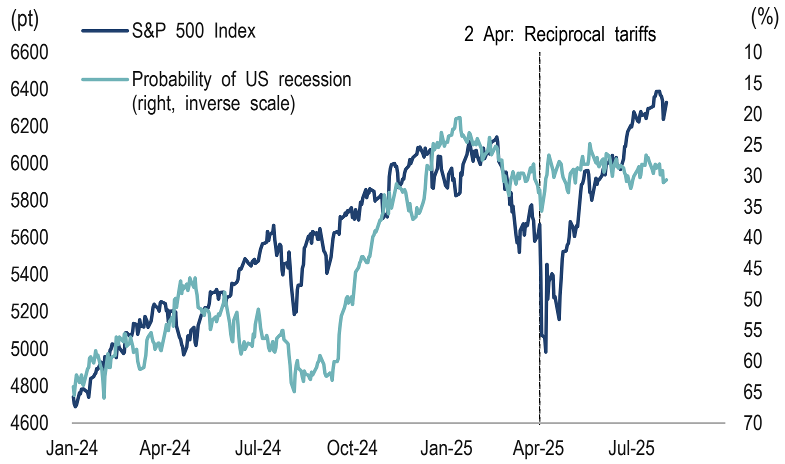
In fact, the ongoing discussions within the ruling and opposition parties and anticipated political frameworks suggest that an increasingly expansionary fiscal stance will be taken. Of course, this expansionary fiscal stance can be seen as a factor in (1) strengthening the BOJ's feeling that its economic and price outlook is "on track" and (2) increasing the incentive for rate hikes. Considering that the surge in prices has become a political issue, as well, the political (administration) side is unlikely to provide strong opposition to rate hikes (preventing the risk of yen depreciation).

Potential obstacles to BOJ raising rates in 2025 (3): Aggressive rate cuts by Fed

The most troublesome factor among the potential obstacles could be the Fed's stance on rate cuts. However, to state our conclusion from the outset, if the Fed were to implement gradual rate cuts starting September in line with our expectations, this would increase the prospects for a "soft landing" with the US economy, and with the market environment being risk-on, this would not act as a major constraint to the BOJ raising rates.

However, if the Fed were forced to implement aggressive rate cuts due to a weakening US economy (labor market), like what happened from last summer onwards, the BOJ would likely maintain a "wait-and-see" stance until that "storm" passed. Currently, the US labor market is just undergoing a "cooling down" as overly optimistic market views have been corrected, and the recession risk is not necessarily rising rapidly.

S&P 500 Index, Recession Probability (10yr – 3mo)



Source: New York Fed, S&P; compiled by Daiwa.

However, as Fed Governor Christopher Waller said, "When labor markets turn, they often turn fast," so the BOJ's policy environment could change dramatically, depending on labor market developments. While these three potential obstacles to the BOJ raising rates this year are expected to be resolved over time, the BOJ will likely be spending the summer monitoring how these issues pan out.

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