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Preview: BOJ Top Keep Rates Unchanged, Amid Tariffs Uncertainty

by

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Executive Summary

- **Expected Decision**: *We expect the Bank of Japan (BoJ) to hold its key short-term interest rate unchanged at around 0.50%.* Regarding its *balance-sheet policies*, in July, the BoJ revealed a comprehensive Quantitative Tightening (QT) plan as an attachment to its monetary policy statement, marking a significant move towards ending decades of extensive stimulus. The BOJ is likely to keep rates unchanged and warn that escalating risks.

- **Policy Discussion**: *The BOJ holds steady as trade tensions and global headwinds build.* The Bank of Japan is expected to signal a cautious policy outlook amid rising external risks. The backdrop of escalating U.S. tariffs has weakened confidence in Japan's export-driven economy—particularly in the auto sector—and prompted concerns over a slowdown in wage growth, which had supported the BOJ's case for normalization. To offset the impact of trade disruptions, the Japanese government has rolled out an emergency package. Still, with global risks mounting and domestic inflation pressures persisting, the BOJ appears set to tread carefully in its post-stimulus normalization path.

  Governor Kazuo Ueda recently stated that further rate hikes remain conditional on a moderate recovery and inflation staying on course toward the 2% target. However, the central bank is now expected to downgrade its growth forecast for fiscal 2025 and push back its projected timeline for meeting its inflation goal, originally targeted for the second half of that fiscal year.

  Despite stronger domestic price pressures—driven by rising food costs and reduced government subsidies—underlying inflation remains uneven. Core inflation in Tokyo rose to a two-year high in April, but consumption remains fragile. The BOJ faces a policy dilemma: act too aggressively and risk choking off a still-fragile recovery, or remain cautious and face renewed currency pressures. Meanwhile, analysts expect the BOJ to delay further rate hikes until at least Q3, with many forecasting no hike this year at all.

- **Changes To Economic Forecasts:** *The BOJ is expected to lower its economic and inflation forecasts*, with Trump's tariff plans raising fears of weaker exports and corporate earnings. Growth and core CPI projections for fiscal 2025 and 2026 are likely to be downgraded, clouding the outlook for stable 2% inflation. A 25% tariff on Japanese autos, a key export sector, has intensified concerns, and major exporters may scale back wage hikes next year, further delaying policy normalization.

Key Picture: Bank of Japan Forecasts – 2024-2026 – From the October 2024 Outlook

	2024*f*			2025*f*		2026*f*	
	Latest Reading	January Report	October Report	January Report	October Report	January Report	October Report
GDP *(real growth, y-o-y)*	1.2	0.5	0.6	1.1	1.1	1.0	1.0
Inflation* *(%, y-o-y)*	3.6	2.7	2.5	2.4	1.9	2.0	1.9

Source: Bank of Japan '*Outlook for Economic Activity and Prices*' October and July 2024. *Note:* 1. Forecasts are for the fiscal year (FY) in Japan from April 1 - 31 March of the following year; 2. Latest GDP reading for Q4-2024; 3. Latest inflation reading for March 2025.

Analysis

- **EXPECTED DECISION**: *On May 1, we expect the Bank of Japan (BoJ) is likely to keep its policy rates unchanged.* In the upcoming monetary policy meeting, we expect the BoJ to keep its key short-term interest rate at "around 0.5%". The BOJ is expected to hold rates steady and caution that rising risks, fueled by US tariffs, could prolong its cautious policy stance.

  Regarding its balance-sheet policies, in July, the BoJ revealed a comprehensive reduction of QE plan as an attachment to its monetary policy statement, marking a significant move towards ending decades of extensive stimulus.

  In terms of *forward guidance*, Governor Kazuo Ueda will likely prepare ground for new hike given recent inflation data reports. After meeting with G20 counterparts, Ueda said the BOJ would continue raising interest rates, provided the economy maintains a moderate recovery and underlying inflation stays on course to reach the 2% target.

- **POLICY DISCUSSION**: *BOJ to hold steady as trade tensions cloud Japan's recovery.* The BOJ is expected to keep interest rates steady at 0.5%, while warning of rising risks to the fragile economy. Mounting trade tensions, particularly new US tariffs, are weighing on business confidence and threatening Japan's export sector, key drivers of its recent recovery.

  BOJ Governor Kazuo Ueda, after meeting with G20 counterparts in Washington, reaffirmed that further rate hikes would depend on the economy maintaining moderate growth and inflation staying on track toward the 2% target. However, the BOJ is now widely expected to revise down its fiscal 2025 growth forecast, previously set at 1.1%, and delay the timeline for achieving stable 2% inflation. Trade tensions have been particularly damaging for Japan's auto sector, a cornerstone of its export-heavy economy. Trump's 25% tariff on Japanese cars has intensified concerns, with wage-driven momentum seen earlier this year has stalled. As a result, analysts polled by Reuters expect the BOJ to hold rates steady through June, with a slim majority forecasting the next hike only in the third quarter.

  Despite external pressures, domestic inflation is building. Core inflation in Tokyo, a leading indicator of nationwide trends, rose to a two-year high in April, fueled by rising food prices and the scaling back of energy subsidies. A broader measure of inflation, excluding fresh food and energy, accelerated to 3.1% year-on-year in April, up from 2.2% in March.

  Nevertheless, the BOJ faces a delicate balancing act. While inflation is rising, the slow pace of domestic demand recovery and global uncertainty complicate the path toward policy normalization. The yen, although recently supported by a weaker dollar, remains vulnerable due to the BOJ's cautious stance, and Washington continues to scrutinize Japan's currency policy.

  To mitigate the impact of tariffs, the Japanese government announced an emergency economic package, including renewed subsidies to curb electricity bills — a move expected to temporarily lower core inflation by up to 0.4 pp. Ultimately, while the BOJ ended its radical stimulus and began raising rates earlier this year, the growing external headwinds suggest it will adopt a more cautious pace going forward. HSBC expects the central bank will not reach a 1% policy rate before the end of 2026, reflecting the increasingly challenging global environment.

- **CHANGES TO ECONOMIC FORECASTS:** *The BOJ is expected to lower its economic and inflation forecasts, as Trump's tariff plans raise concerns over weaker exports and corporate earnings.* The BOJ may revise down its fiscal 2025 GDP growth forecast, currently at 1.1%, as well as its core CPI projections of 2.4% for fiscal 2025 and 2.0% for fiscal 2026. The central bank had anticipated achieving stable 2% inflation around fiscal 2026, but the risk of an economic downturn now clouds that outlook.

  Trump's plan to impose steep tariffs on Japanese goods has raised fears of falling exports and weaker corporate profits. Especially concerning for Japan is the 25% tariff on cars, a cornerstone of its export-driven economy. Thus, policy normalization may be delayed as trade tensions prompt major exporters — previously leaders in wage hikes — to scale back or pause increases next year.

- **MACROECONOMIC ANALYSIS:** *Although growth is picking up, rising trade barriers and sluggish domestic demand could hamper the recovery.* Japan's economy has clearly improved. Real GDP rose 1.1% year-over-year in Q4 2024, a sharp rebound from the 0.7% contraction in early 2024. Stronger wage growth supported household spending, while business investment, government spending, and frontloaded trade ahead of U.S. tariffs also boosted growth.

Stronger growth and rising inflation suggest Japan is moving away from its deflationary past. Wage gains are expected to further lift consumer spending, although elevated commodity prices and global headwinds pose challenges. Inflation data points to persistent pressures: headline inflation hit 3.6% in March, while core-core inflation rose to 2.8%. However, much of the inflation stems from food and energy. Excluding these, inflation was only 1.6%, and services inflation slowed to 1.4%, signaling weaker underlying inflation. High food and energy costs strain household budgets despite strong wage hikes. Real earnings fell 1.2% in February, and excluding bonuses, contractual wages dropped 2.5%. Some of this reflects base effects from last year's wage surge.

Spring wage negotiations show some promise: unionized workers secured average raises of 5.5%, slightly above last year's 5.1%. The government also plans to lift the minimum wage from 1,055 to 1,500 yen over five years, requiring annual increases of around 7%. Consumer spending has started to recover modestly. Real consumption rose 1.3% year-over-year in February, an improvement from near-flat growth in 2024. Cooling food and energy inflation should further support spending, though rice prices remain a concern. A stronger yen — appreciating from 157.8 to 142.76 per U.S. dollar by mid-April — could also ease imported inflation. The yen's rise reflects expectations of U.S. Fed rate cuts in response to Trump's new tariffs, which are likely to slow U.S. growth.

In response to these risks, Japan announced new stimulus measures focused on supporting businesses, retaining employment, boosting consumption, and strengthening industrial competitiveness.

- **MARKET IMPLICATIONS:** JGB yields are declining alongside U.S. Treasury yields, as markets see little likelihood of near-term tightening by the BOJ. In the fixed-income space, as of April 28 and since the last meeting in March *i)* 10y JGB yield decreased by 17 bps to 1,33(+21 bps y-t-d); and *ii)* 2y JGB edged down by 15 bps to 0.68 (+3 bps y-t-d). In the currency space, amid fading trade optimism and BOJ uncertainty, USD/JPY lost 4.4% since the last meeting in March and is around 142,2 (-9.4% y-t-d). In the equity space, Nikkei 25 declines as Trump tariffs roil markets. As of April 28, and since the last meeting in January, the Nikkei 225 fell by 5.1% to 35,839.99 (-8.8% y-t-d).

- **APPENDIX (Macro Background):** *Q4 GDP growth marked the third consecutive quarter of growth.* According to the final estimate, the GDP expanded by 0.6% q-o-q (*c:* 0.7%; *p:* 0.4%) in the Q4. It marked the third consecutive quarter of growth. Private consumption saw a slight downward revision, remaining flat instead of the 0.1% growth initially reported (*p:* 0.7%). Business investment expanded by 0.6%, exceeding the preliminary 0.5% reading (*c:* 0.3%; *p:* 0.1%). Government spending grew for the fourth straight quarter, rising 0.4%, (*c*: 0.3%; *p*: 0.1%). Net trade contributed 0.7 pp to overall growth, with exports rising for the third consecutive quarter at 1.0%, though lower than 1.5% in Q3, while imports fell 2.1%, marking their first decline since Q1 2024, after rising 2.0% in Q3. On an annualized basis, the economy expanded by 2.2%, accelerating from the 1.4% revised growth in Q3.

  Manufacturing activity fell to its second-lowest level in over a year, signaling modest deterioration in output. In February, Jibun Bank composite PMI rose to 51.1 (*p:* 48.9). Services PMI increased to 52.2 (*p:* 50.0). Manufacturing rose slightly to 48.5 (*p:* 48.4). Business sentiment fell to its lowest level since June 2020, driven by widespread concerns over U.S. trade tariffs and the global economic outlook.

Japan's unemployment rate rises. ***The unemployment rate*** edged down to 2.4% in February (*c*: 2.5%; *p*: 2.5%). The number of unemployed declined by 60K to 1.74 ml while employment decreased by 110K to 68.16 ml. Nominal wages rose by 3.1% y-o-y (*p:* 1.8%) in February.

Core inflation hits 2-year peak. In March, *CPI inflation* eased off to 3.6% y-o-y marking the lowest reading since November. Food prices increased the least in three months (7.4% vs. 7.7% in December). Meanwhile, electricity (8.7% vs. 9.0%) and gas costs (2.3 % vs. 3.4%) cooled further amid energy subsidies. Core inflation was up to 3.2% y-o-y in March (*c*: 3.2%; *p:* 3.0%).