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Review: BOJ Keeps Rates on Hold, While Assessing the Impact of Tariffs

by

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Executive Summary

- **Decision Made**: *The Bank of Japan (BoJ) maintained its policy rates in May*. The BoJ board voted in an unanimous decision to keep its short-term policy rate unchanged at 0.50%. Governor Kazuo Ueda and other officials flagged rising risks from uncertain trade policies. The BOJ said it will continue raising rates if its economic and inflation outlook holds.
- **Policy Discussion:** *The Bank of Japan kept interest rates unchanged for a second straight meeting, as growing export risks from Trump's tariffs cloud the economic outlook.* The central bank also downgraded its growth forecast, citing rising global trade uncertainty but maintained inflation is broadly on track to reach its 2% target, suggesting future rate hikes remain possible. Governor Ueda defended the rate-hike stance as a preemptive move to avoid abrupt tightening later, as seen in the US and Europe post-Covid. However, the weak economic and inflation outlook makes further rate increases more difficult.

  The decision followed U.S.-Japan trade talks that ended without progress. Ueda noted the BOJ's forecasts assume some trade deal progress and stable supply chains, but admitted overall uncertainty has grown. Tariffs are expected to weigh on growth, corporate profits, and sentiment, though this drag may ease as global economies recover. Underlying inflation is forecast to stagnate in the short term, delaying the 2% target timeline. Still, as labor shortages persist and inflation expectations rise, the BOJ expects inflation to gradually align with its target.

  Markets viewed the BOJ's tone as dovish, pushing bond yields and the yen lower. While the BOJ reiterated its inflation goal would be met "in the latter half of the projection period," the unchanged wording signaled a likely delay—reinforcing investor expectations of a cautious policy path.
- **Changes to Economic Forecasts:** *The BOJ sharply cut its growth forecast, citing the impact of US. tariffs and rising global trade uncertainty under Trump's policies.* It now expects just 0.5% growth for FY2025, down from 1.1%, with modest rebounds to 0.7% and 1.0% in subsequent years. The central bank also warned that higher tariffs could slow exports, delay investment, and weaken confidence. Despite inflationary pressure on households, the BOJ sees core inflation near its 2% target, projecting 2.2% for the current fiscal year. Inflation is expected to ease to 1.7% in 2026 and rise slightly to 1.9% in 2027. Assuming trends hold, the BOJ signaled it may continue raising rates.

  Risks to outlook remain high, including trade tensions, geopolitical uncertainty, and a slowing Chinese economy. Domestically, labor shortages and volatile prices could also shape inflation outcomes.

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

	2024*f*			2025*f*		2026*f*		2027*f*
	Latest Reading	May Report	January Report	May Report	January Report	May Report	January Report	May Report
GDP *(real growth, y-o-y)*	1.2	0.7	0.5	0.5	1.1	0.7	1.0	1.0
Inflation* *(%, y-o-y)*	4.0	2.7	2.7	2.2	2.4	1.7	2.0	1.9

Source: Bank of Japan '*Outlook for Economic Activity and Prices'* May and January 2025. *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 January 2025.

Analysis

- **DECISION MADE**: *In line with our preview and consensus, on May 1, the Bank of Japan (BoJ) remained on hold.* The BoJ kept its the key short-term interest rate at "around 0.50%" in an unanimous vote. In terms of *forward guidance*, Governor Kazuo Ueda and other officials warned of heightened risks stemming from unpredictable trade measures and international responses. In its policy statement, the central bank emphasized that it will continue raising its policy rate and adjusting monetary accommodation if its economic and inflation outlook materializes.

  In terms of *balance sheet policies*, in July 2024 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.

- **POLICY DISCUSSION:** *The Bank of Japan keeps rates unchanged for a second consecutive meeting amid export risks from Trump's tariffs.* The BOJ held interest rates steady and lowered its growth outlook on Thursday, citing rising uncertainty from US tariffs that threaten Japan's economic recovery. However, the central bank maintained that inflation remains broadly on track to reach its 2% target in the coming years, suggesting that rate hikes may be delayed but not derailed.

  Although the economy remains weak, Ueda has justified his rate hikes by saying it's important to stay ahead of the curve and avoid the kind of abrupt, aggressive tightening the Fed and ECB had to implement after the post-Covid inflation spike. However, with a bleak outlook for both the economy and inflation, the central bank has made it harder to keep raising interest rates.

  The BOJ's latest move follows recent trade talks between Washington and Tokyo that reportedly ended without a breakthrough. During the press conference, Governor Ueda emphasized that while bank's forecasts assume some progress in trade talks and no major disruption to supply chains, the overall outlook is more uncertain than before. Tariffs are expected to weigh on Japan's economy by slowing global growth, dampening corporate profits, and prompting caution among consumers and businesses. Still, the BoJ anticipate this pressure to ease as overseas economies begin to recover. Regarding the prices, underlying inflation is expected to stagnate for a while before gradually picking up again.

  The Bank of Japan expects inflation to remain near its 2% target over the coming years, though underlying inflation may be sluggish in the near term due to slower growth. As such, Governor Ueda highlighted that that timeline for reaching our 2% inflation target will be pushed back. As labor shortages intensify and inflation expectations rise, underlying inflation is projected to gradually align with the target. However, as mentioned, significant uncertainties around global trade and policy pose downside risks to both growth and inflation. The BOJ plans to continue adjusting interest rates based on economic conditions but will proceed cautiously, monitoring domestic and global developments to ensure stable achievement of its price stability goal.

  Markets interpreted the BOJ's cautious tone on global risks as dovish, which added downward pressure on yields and the yen. Although the central bank emphasized both upside and downside risks, it signaled a commitment to policy flexibility. At the same time, the BOJ reiterated its view that inflation will reach the 2% target "in the latter half of the projection period." While the wording remained unchanged, it effectively indicated a delay in the timeline—further weighing on the yen.

- **CHANGES TO ECONOMIC FORECASTS:** *The BOJ has sharply reduced its growth outlook for the Japanese economy, citing the negative impact of US tariffs and growing global trade uncertainty driven by President Trump's policies.* The BOJ highlighted that higher tariffs could hurt Japan's economy by slowing exports, delaying investment, and weakening business and consumer confidence. Reflecting these concerns, the BOJ downgraded its growth projections in Thursday's quarterly outlook: it now expects the economy to grow just 0.5% in the fiscal year ending March 2026, down from the 1.1% forecast in January. Growth is expected to pick up slightly to 0.7% in FY2026 and 1.0% in FY2027.

Adding to the Bank of Japan's policy challenges is the continued pressure of inflation on Japanese households. The central bank expects inflation to remain near its 2% target in the short term. The BOJ now projects that core consumer inflation—excluding volatile fresh food prices—will be 2.2% for the current fiscal year, slightly lower than the 2.4% forecast made in January. It expects inflation to slow to 1.7% in the year ending March 2027 and to edge up to 1.9% the following year. Given the persistence of domestic inflation and steady wage growth, the BOJ indicated it would continue pursuing further interest rate increases, assuming economic and inflation trends evolve as expected.

Therefore, Japan's economy is expected to slow in the near term due to weaker global demand, trade policy uncertainty, and declining corporate profits. Despite the slowdown, tight labor markets are expected to keep nominal wage growth strong, supporting modest gains in private consumption, aided further by government measures. Over time, inflation is expected to pick up as growth resumes, labor shortages intensify, and inflation expectations rise. Potential growth should improve gradually, driven by productivity gains, human capital development, and supportive policy.

Japan's economic outlook faces several key risks. Trade tensions, geopolitical instability, and uncertainties in major economies like China could dampen global demand, weaken sentiment, and disrupt supply chains, raising import costs. Domestically, labor shortages may drive structural shifts but also pose constraints if capital investment doesn't keep pace. Inflation risks include volatile commodity prices, wage dynamics, and currency fluctuations, which could push inflation either above or below projections depending on how firms and households respond.

- **MARKET IMPLICATIONS:** *Yen slides with JGB yields after BOJ cuts economic growth forecasts*. Markets interpreted the BOJ's cautious tone on global risks as dovish, prompting strong buying of JGBs and a sharper-than-expected drop in the 10-year yield. While the BOJ kept its rate hike stance, this was likely aimed at preventing yen weakness during Japan's trade talks in Washington. After the BOJ decision, yields on 10Y JGB dropped to a three-week low of 1.26%. 2Y JGB also fell and trades around 0.63%*The yen fell toward a two-week low against the dollar.* The USD/JPY climbed 1.12% to 144.54, and the EUR/JPY gained 0.86% to 163.33. *Japanese stocks closed higher.* Nikkei 225 closed up 1.22% in Tokyo, reaching a new one-month high.