Japan Event Flash

December 2025

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Bank of Japan to continue interest rate hike path under Takaichi Administration

At its December 2025 monetary policy meeting, the Bank of Japan (BOJ) raised its policy interest rate from around 0.5% to around 0.75%. This marks the highest policy rate level in the 30 years since 1995. As Governor Ueda had effectively signalled the December rate hike in advance, the market had already anticipated this rise.

The Bank of Japan cited two main factors behind this rate hike:

1. The initial phase of the 2026 spring wage negotiations is proceeding smoothly, and
2. The impact of Trump tariffs on Japanese corporate earnings generally remains limited.

Though not explicitly stated, the heightened risk that yen weakness could lead to underlying inflationary pressure is also considered a factor behind the hike. Furthermore, amid concerns over the adverse effects of yen weakness on people's livelihoods, and with the Trump administration urging the BOJ to correct yen weakness through interest rate hikes, the Takaichi administration, which traditionally favours low interest rates, appears to have had no choice but to accept the BOJ's rate hike.

Regarding future monetary policy management, the BOJ stated that, given the current extremely low level of real interest rates, if the economic and price outlook presented in its "Outlook Report" materializes, it will continue to raise the policy interest rate and adjust the degree of monetary easing in line with improvements in economic and price conditions. However, Governor Ueda avoided making specific comments at the press conference about the future pace of rate hikes or the level of the neutral interest rate. This likely reflects an intention to preserve flexibility in future monetary policy.

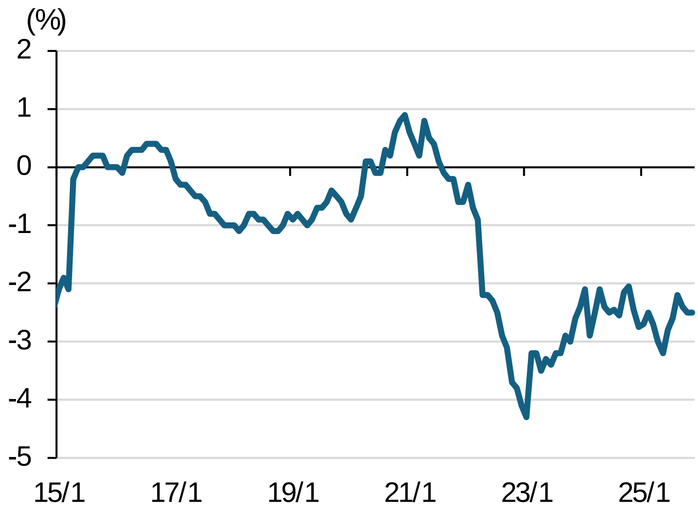
Key points to watch going forward will be the pace of the BOJ's rate hikes and the terminal rate. Given that real interest rates remain extremely low even after this rate hike, the Bank of Japan is expected to raise rates at a gradual pace of 0.25% every six months (Exhibit 1). Given the energy price decline exerting downward pressure on inflation under the Takaichi administration's policies, core CPI is projected to temporarily dip below 2% year-on-year in fiscal 2026 (Exhibit 2). Therefore, we do not see compelling reason for the BOJ to rush into raising interest rates. The terminal rate is likely to settle around 1.25-1.5%. For the Takaichi administration, which has traditionally pursued a high-pressure economy (low interest rates + aggressive fiscal policy), raising rates beyond the 1.25-

1.5% range is likely unacceptable. However, since the BOJ estimates the neutral interest rate at 1.0-2.5%, caution is warranted regarding the risk that the BOJ may be forced to raise rates closer to the upper end of its neutral interest rate range sooner than expected if yen depreciation pressure further intensifies.

In 2026, amid steady interest rate hikes by the BOJ, Japan's long-term interest rates are likely to rise gradually, targeting the low to mid-2% range (Exhibit 3). Against the backdrop of the Takaichi administration's proactive fiscal policy, increased issuance of government bonds is anticipated. Furthermore, the Bank’s gradual reduction of government bond purchases (QT) will also contribute to a modest rise in long-term interest rates from a supply-demand perspective. Given that markets have already priced in the BOJ's gradual rate hikes, the foreign exchange market is unlikely to see significant yen appreciation. We expect the dollar-yen to continue trading in a range centred around 155 (Exhibit 4).

Despite rising long-term interest rates, we anticipate the Japanese stock market will reach new all-time highs in 2026. By the end of 2026, the Nikkei 225 is likely to rise to the 55,000 level. With nominal GDP growth expected to remain at a relatively high annual rate of around 3-4%, corporate profits for fiscal 2026 are projected to accelerate to approximately +13% year-on-year. Therefore, provided the rise in long-term interest rates remains moderate, the upward trend in stock prices is expected to continue. Looking ahead, the Japanese stock market is likely to continue its upward trend. This is underpinned by robust corporate earnings, expansionary fiscal policy, increased shareholder returns driven by improved corporate governance, and the fact that Japanese stocks remain undervalued relative to their U.S. counterparts.

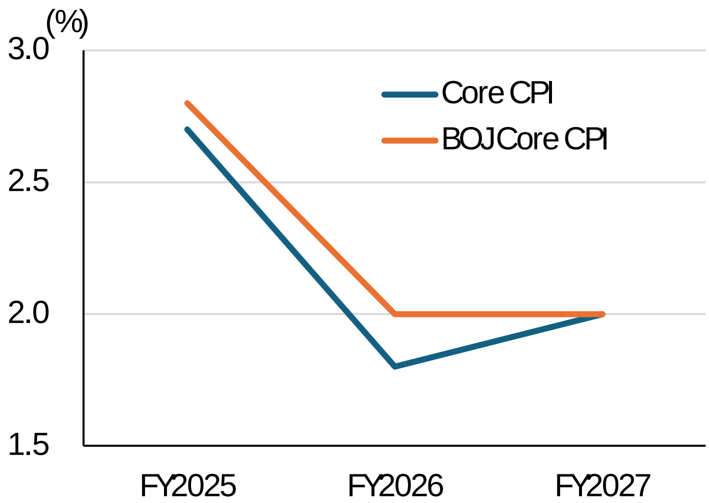
Exhibit 1: Real Policy Rate in Japan



Source: BOJ, MIC, MUFG: Trust Bank

Note: Real Policy Rate = Policy Rate－Core CPI

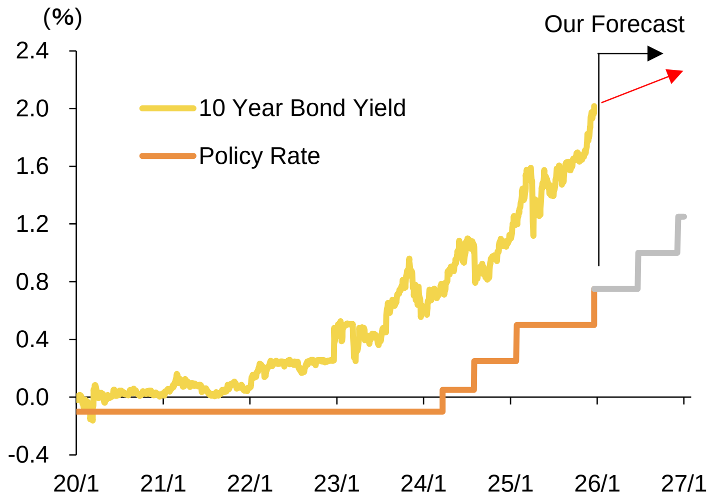
Exhibit 2: BOJ’s Price Outlook



Source: BOJ, MUFG: Trust Bank

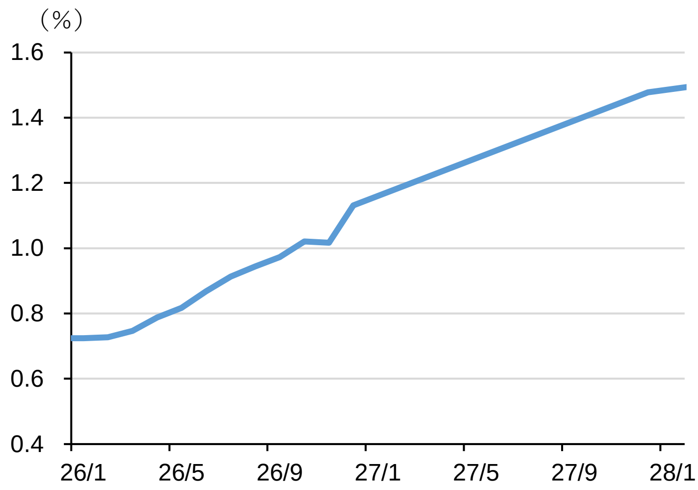
Note: Excerpt from Outlook Report (October 2025)

Exhibit 3: Japan’s Policy Rate and 10-Year Bond Yield



Source: Bloomberg, MUFG: Trust Bank

Exhibit 4: The Path of the BOJ's Policy Rate as Priced into the Yen OIS Market



Source: Bloomberg, MUFG: Trust Bank
Note: As of December 19, 2025

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