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Ueda downplays political friction but military Keynesianism poses challenge

Key takeaways

- The Bank of Japan (BOJ) held rates steady again, citing continuing uncertainty from US protectionism.
- BOJ Governor Ueda Kazuo downplayed the significance of domestic politics as a factor in the BOJ's decision-making, but the new government's fiscal policies – particularly its determination to raise defense spending – could raise tensions.

The Bank of Japan (BOJ) kept its policy rate at 0.50% at its 29-30 October policy board meeting. This decision was not unexpected, and Governor Ueda Kazuo cited continuing uncertainty from US trade policy as justifying the decision to leave policy unchanged. In his press conference Thursday Ueda stressed that he wants to see how tariffs impact the outlook for wage increases in next year's negotiations, citing the risk that lower earnings could make employers more reluctant to raise wages.

More broadly, the bank's quarterly *tenbō* report suggests that the BOJ may not be in a particular hurry to hike again, pointing to "sluggish growth" going forward due to trade tensions and slower global growth. The report also expects core-core inflation to fall below target as the impact of higher food prices fades, which could induce further caution on the part of the BOJ as it continues to aim for stable 2% inflation. That said, Ueda did not rule out the possibility of a rate hike in December if warranted by the data.

The BOJ's decision to hold – and the cautious tone taken by Ueda in his remarks – may momentarily reduce concerns about tensions between the BOJ and the Takaichi government, though Ueda argued that the BOJ will not be constrained by the domestic political situation if the data supported a rate hike. However, the potential for conflict between the Takaichi government and the BOJ cannot be so easily dismissed.

Fundamentally, the Takaichi government, while still talking of "responsible fiscal expansion," has continued to send signals that it is determined to deploy fiscal stimulus to achieve its strategic objectives, particularly higher defense spending. Prime Minister Takaichi Sanae's inclination towards "military Keynesianism" is mounting; she has already pledged to use the forthcoming supplemental budget to raise defense spending to 2% of GDP ahead of the FY2027 target – which could add JPY 1tn to the budget on top of other measures – and has indicated to the US that Japan could increase its defense spending further. (Defense Minister Koizumi Shinjirō reiterated this position in a meeting with his US counterpart on Wednesday, 29 October.) The government has not indicated how it intends to pay for larger defense budgets, though Finance Minister Katayama Satsuki did not rule out deficit spending in a television appearance last week, arguing that policy matters like national defense supersede more quotidian concerns.

Between Takaichi's dovish inclinations, Ishin no Kai's hostility to tax increases (for defense or other purposes), and Takaichi's efforts to shift the balance of power within the Liberal Democratic Party (LDP) in favor of fiscal doves, she may be laying the groundwork for a significant fiscal policy shift. The latest sign of the shift within the LDP is that former LDP secretary-general Moriyama Hiroshi announced that he is resigning from the LDP's tax commission, becoming the latest fiscal hawk to leave a key fiscal policy institution that is increasingly dominated by Takaichi's allies. To be sure, the scale of the Takaichi government's shift may not be fully apparent until mid- to late 2026, after the government releases key policy documents that will chart the mid-term direction of fundamental policies. Of course, the government's basic policies for the FY2027 budgetary process will be a key indicator, in which the government could soften or abandon prevailing fiscal targets. But next year could also be important if, as Takaichi has already suggested her government will do, the government updates Japan's three basic strategic documents, which will outline intentions for raising defense spending.

If the Takaichi government carries out this pivot, it is difficult to see how the BOJ could escape pressure from the government, since, as Constitutional Democratic Party (CDP) Secretary-General Azumi Jun, a former finance minister, said of the government's fiscal intentions, "If we pursue expansionary fiscal policy while inflation is already accelerating, long-term interest rates will rise, the yen will weaken further, and inflation will be exacerbated." Accordingly, while both the government and the BOJ have sought to downplay the existence of tension between them, the Takaichi government's ambitions may put it on a collision course with the BOJ.

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