19 December 2025

As Bank of Japan hikes, yen weakness looms as challenge

Key takeaways

- The Bank of Japan (BOJ) raised rates as expected on 19 December, but the yen weakened.
- This suggests that exchange rates could be serving as a barometer of sentiment about fiscal policy as well as monetary policy.
- How political and monetary authorities manage yen weakness is emerging as a major issue for 2026, though Governor Ueda Kazuo expressed confidence in the resilience of Japan's economy.

As widely telegraphed by Bank of Japan (BOJ) officials ahead of the 18-19 December policy board meeting, the bank announced Friday that it would raise short-term rates by twenty-five basis points to 0.75%. Policy rates are now at their highest level in thirty years, while the move pushed long-term rates above the psychological threshold of 2%.

Despite narrowing the interest rate differential with the US dollar, the yen weakened rather than strengthened against major currencies. This movement likely reflects the neutral tone from Governor Ueda Kazuo in his remarks Friday afternoon, suggesting that the BOJ's pace could still be slow and at the mercy of the Takaichi government. It may also suggest that, with the market for long-term government debt still constrained by the BOJ's holdings and activity, the currency could be the main lever for markets to register their concerns about the direction of fiscal policy under Prime Minister Takaichi Sanae. It is worth considering whether the market reaction Friday reflects the difficulties Takaichi faces in credibly convincing investors that she is serious about "responsible" fiscal expansion.

As such, the BOJ's meeting this week suggests that the yen's value could become a central issue for both the government and the BOJ in 2026. For the government, yen weakness could become a stubborn challenge for Takaichi if it contributes to persistent above-target inflation and frustrates efforts to boost real incomes, which could in turn weaken the prime minister's standing. This could ultimately force the government to intervene to strengthen the yen again if it approaches JPY 160/USD again, though the prime minister has in the past questioned how detrimental a weak yen is and the efficacy of intervention could be limited as long as investors question Takaichi's commitment to responsibility. Ongoing yen weakness could also contribute to friction with the US and undermine Takaichi's defense ambitions to the extent that Japan is dependent on imported military equipment. It may well have been yen weakness that led the Takaichi government to sign off on this month's rate hike despite Takaichi's past misgivings about monetary policy normalization – and was clearly a factor in the BOJ's own thinking, for, as Ueda acknowledged on Friday, yen weakness was a factor that led multiple board members to favor a rate hike for fear that rising import costs could anchor inflation expectations above the BOJ's target. If yen weakness continues, it could remain a driver of hawkishness on the policy board, potentially triggering friction with the government but also challenging Ueda's commitment to a gradual path of normalization. Ueda stressed Friday that one reason why the bank hiked now was to avoid the need for a larger hike later, which he said could impose significant costs on the economy and financial system.

That said, the main reason the BOJ finally raised rates again is that it is confident in the strength of the Japanese economy. Ueda noted the diminishing impact of US tariffs and the positive signs for wage increases in the 2026 *shuntō* and also stressed that monetary policy remains both broadly accommodative – real rates are still negative – and below the neutral rate of interest. The bank appears confident that underlying structural changes, namely labor market tightness leading to higher wages and inflation, continue to drive economic behavior, justifying the ongoing commitment to policy normalization.

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