

Ishiba's departure gives BOJ pause for thought on rate hikes

By Leika Kihara, Reuters, September 9, 2025

- **Politics won't derail BOJ rate hike plan but may affect timing**
- **Takaichi, proponent of low rates, seen frontrunner in LDP race**
- **Rising inflation may prod Takaichi to water down stimulus calls**
- **Fiscal stimulus, yield spike may affect BOJ's QT, rate hike plan**

TOKYO - The appointment of a new Japanese prime minister next month could give the central bank more reasons to go slow on its next interest rate hike, especially if the next leader is wary of seeing borrowing costs rise too quickly. While the Bank of Japan's main concern remains domestic inflation and the economic hit from U.S. tariffs, uncertainty around who becomes next leader or what their policies might be adds a layer of risk to deliberations around monetary settings. Prime Minister Shigeru Ishiba announced his decision to resign on Sunday after a string of election defeats including a July upper house poll. The focus has now shifted to who will replace him. Japanese bond yields fell on Tuesday on reports Sanae Takaichi, a proponent of government stimulus and monetary easing, would run in the Liberal Democratic Party's leadership race in October, which could make her the next prime minister. "The resignation of Japan's prime minister Ishiba and the unfolding leadership contest at the ruling LDP will likely deter the Bank of Japan from raising rates in October," analysts at Evercore ISI wrote in a research note, adding they were pushing back their call for the next hike provisionally to January.

The departure of Ishiba, seen as a fiscal hawk who gave a nod to gradual BOJ rate hikes, pushed down the yen and bond yields as investors reduced bets of a near-term rate hike. Money markets now show about a 20% chance the BOJ will hike rates by the end of October, down from 46% odds a week ago. The LDP will choose his successor in a vote on October 4, who will then seek parliament approval to become head of government. A new administration may not be formed until mid-October, creating an uneasy political vacuum ahead of the BOJ's policy meeting on Oct. 29-30. While the wider political uncertainty won't derail the BOJ's plan to continue raising rates gradually, it could affect the timing of the next hike, said three sources familiar with its thinking. "The BOJ doesn't need to hike in the midst of turbulence," one of the sources said. "It is in no rush and has a free hand on the timing, as long as it gets another rate hike done possibly by early next year." "The key is whether the hit from U.S. tariffs on Japan's economy would be within expectations, rather than what happens with politics," another source said on the rate-hike timing.

FISCAL COMPLICATIONS

Who wins the race will also have a significant impact on the pace and timing of BOJ rate hikes, analysts say. Conservative lawmaker Takaichi is one of the frontrunners and previously a strong advocate of "Abenomics"-style mix of fiscal and monetary stimulus of deceased premier Shinzo Abe. She stands out for her criticism of the BOJ's rate hikes. Another contender is Shinjiro Koizumi, a proponent of deregulation whose views on monetary policy are little known. Both were top candidates in the LDP leadership race in September 2024 with Takaichi winning the most votes in the first round, only to be defeated by Ishiba in the run-up. There is uncertainty on whether Takaichi will do as well this time, with some of her political backers having lost their jobs or clout due to a scandal that hit the former Abe faction. Even if she wins, Takaichi may need to water down calls for ultra-low rates with rising inflation, rather than the risk of deflation, now a bigger problem for the public, analysts say. "Support for reflationist-minded lawmakers has shrunk within the LDP. As such, Takaichi will need to restrain her calls for reflationist policies to some extent to win broad support within the party," said BNP Paribas chief Japan economist Ryutaro Kono.

Whoever ends up winning the leadership race would ultimately run a minority coalition and need support from opposition parties to pass the budget through parliament. Small opposition parties seen as candidates for forming an alliance are against an early BOJ rate hike, or have called on the central bank to tread carefully in rolling back stimulus. While politics may create hurdles for a near-term rate hike, growing calls from most candidates and opposition parties for bigger spending could require the BOJ to lift rates over the longer-term to tame inflationary pressures.

The worst-case scenario for policymakers would be a sustained, sharp rise in bond yields triggered by investors' concern over Japan's loss of fiscal discipline. In such an event, the government may pressure the BOJ to halt its quantitative tightening (QT) plan and step into the market with emergency bond purchases, some analysts say. Such a move would be a major setback in the BOJ's efforts, which began last year, to gradually taper its huge bond buying. All this would give the BOJ reason to sit on the sidelines until the political dust settles. But waiting too long also carries risks. Inflation has held above the BOJ's 2% target for three years, and price pressures have broadened beyond stubbornly high food costs as a tight labour market pushes up wages. "The BOJ must be cautious. But it also understands that waiting too long is not without risk," a third source said.

Will ECB be left holding central bank 'independence' baton?

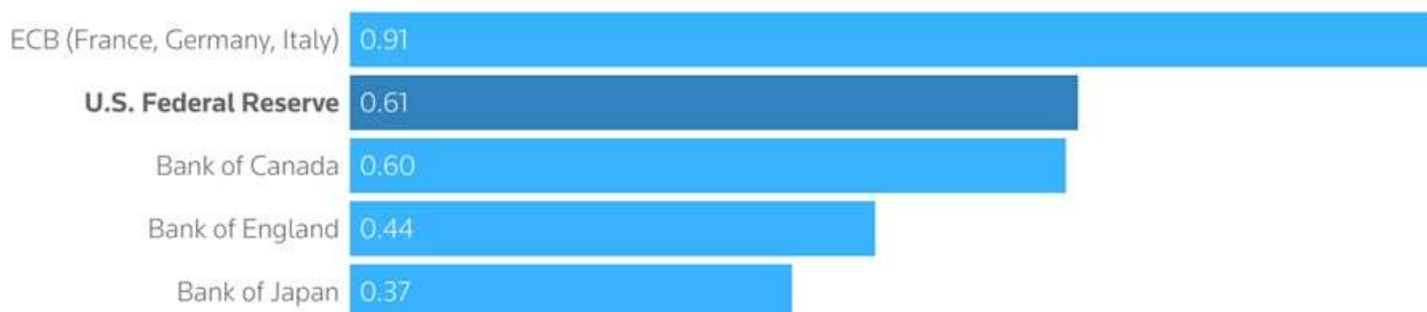
Mike Dolan, Reuters, September 9, 2025

If central bank independence is all it's cracked up to be, then the European Central Bank may be in a good spot, as its odd multinational structure likely leaves it better protected from political interference gnawing at its peers. Whether it proves a boon or a drag is an open question. U.S. President Donald Trump's administration is already seeking to reshape the structure and remit of the Federal Reserve, long a standard bearer for effective economic management. Many investors suspect the process is both inevitable and damaging. Whatever the public rationale for more political influence over the once fiercely independent institution, the suspicion is that the extraordinarily high U.S. public debt means Washington needs the Fed to play ball by keeping interest servicing costs manageable. The U.S. central bank's ability to accomplish that task without compromising control of inflation, which is still above its 2% target, is what has been unnerving the long end of the bond market and, arguably, the dollar exchange rate. Washington may not be alone in this central bank rethink.

Japan's ruling Liberal Democratic Party is moving to select a new prime minister after the resignation of Shigeru Ishiba, and the current favorite to take the role, LDP veteran Sanae Takaichi, is opposed to the Bank of Japan's desire to push interest rates higher and has advocated greater co-ordination between the BOJ's monetary policy and government fiscal policies. The BOJ's political independence may already be tenuous relative to its Group of Seven peers, of course, but the direction of travel in highly indebted Japan is not lost on edgy world bond markets. The Bank of England, whose operational independence is less than 30 years old, may seem more secure. But British debt pressures are building too and the BoE's relatively tight relationship with government on its inflation target and balance sheet usage sees it rank relatively low on the G7 list of central bank autonomy. That then leaves the ECB. Its complex-multinational structure was once seen as its Achilles' heel, but its long-criticized bureaucracy may actually be excellent armor against attempts at government capture.

US Fed independence lags well behind euro zone peers

G7 central bank independence scores as of 2023, with 1 being the most independent possible



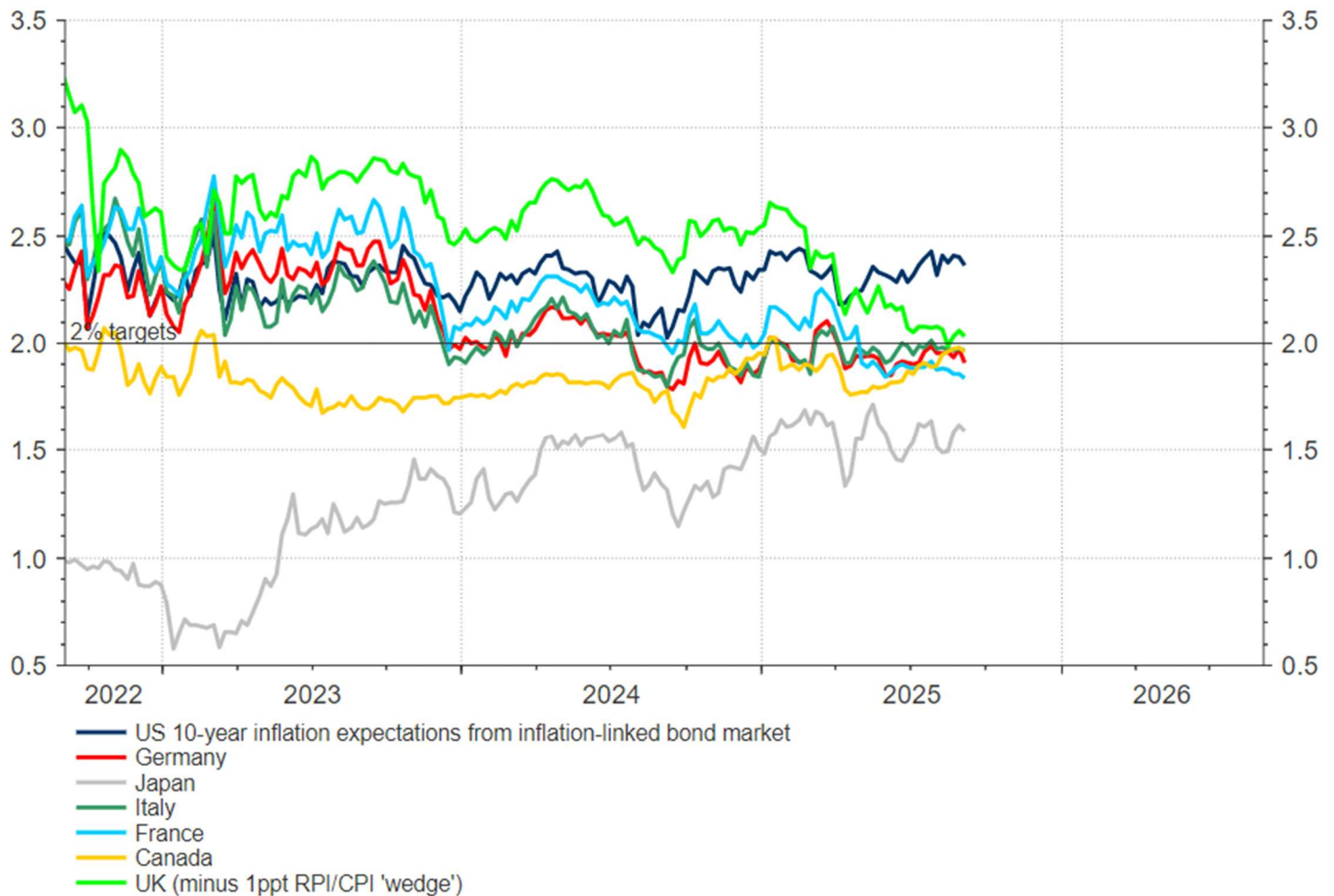
Note: European Central Bank (ECB) shows an average of France, Germany and Italy scores

Source: Romelli, D., (2022, 2024), Central Bank Independence – Extended (CBIE) Index

CAN'T HAPPEN HERE

All G7 central banks are ultimately arms of government, of course. However, direct political influence over interest rate setting has been shunned for decades to avoid compromising inflation control with the feverish demands of electoral cycles. The very perception of that distance has been important for monetary policymakers seeking to maintain market credibility regarding their pursuit of stable prices over the long term. But history shows that when extraordinary financial, economic or even military crises dictate, central banks clearly prioritize stability over all other concerns and are therefore willing to facilitate massive government borrowing when needed. The COVID-19 pandemic of 2020 is the most recent example. The question now is whether developed nations' historically high public debt loads and the unwillingness of governments - or electorates - to rein them in constitute a "crisis" of those proportions. Optically at least, the ECB appears better protected, as none of its constituent member governments can exert the kind of control seen in Washington, Tokyo or even London. Additionally, the ECB's autonomy to control inflation is rooted in its constitution and treaties, rather than easily changeable laws or Treasury guidance. In some eyes, ECB independence was partially blurred by the euro government bond-buying efforts in the 2010s. With the eurozone facing its own existential crisis in 2010-2012, the ECB proved adept at finding wiggle room in what were originally viewed as prohibitions on government debt support as it gobbled up government bonds to prevent the euro's collapse. And its more recent commitment to smoothing monetary policy transmission across the bloc gives it leeway to address "excessive" gaps between sovereign bonds within the zone.

US INFLATION EXPECTATIONS HIGHEST IN G7



Source: LSEG Datastream

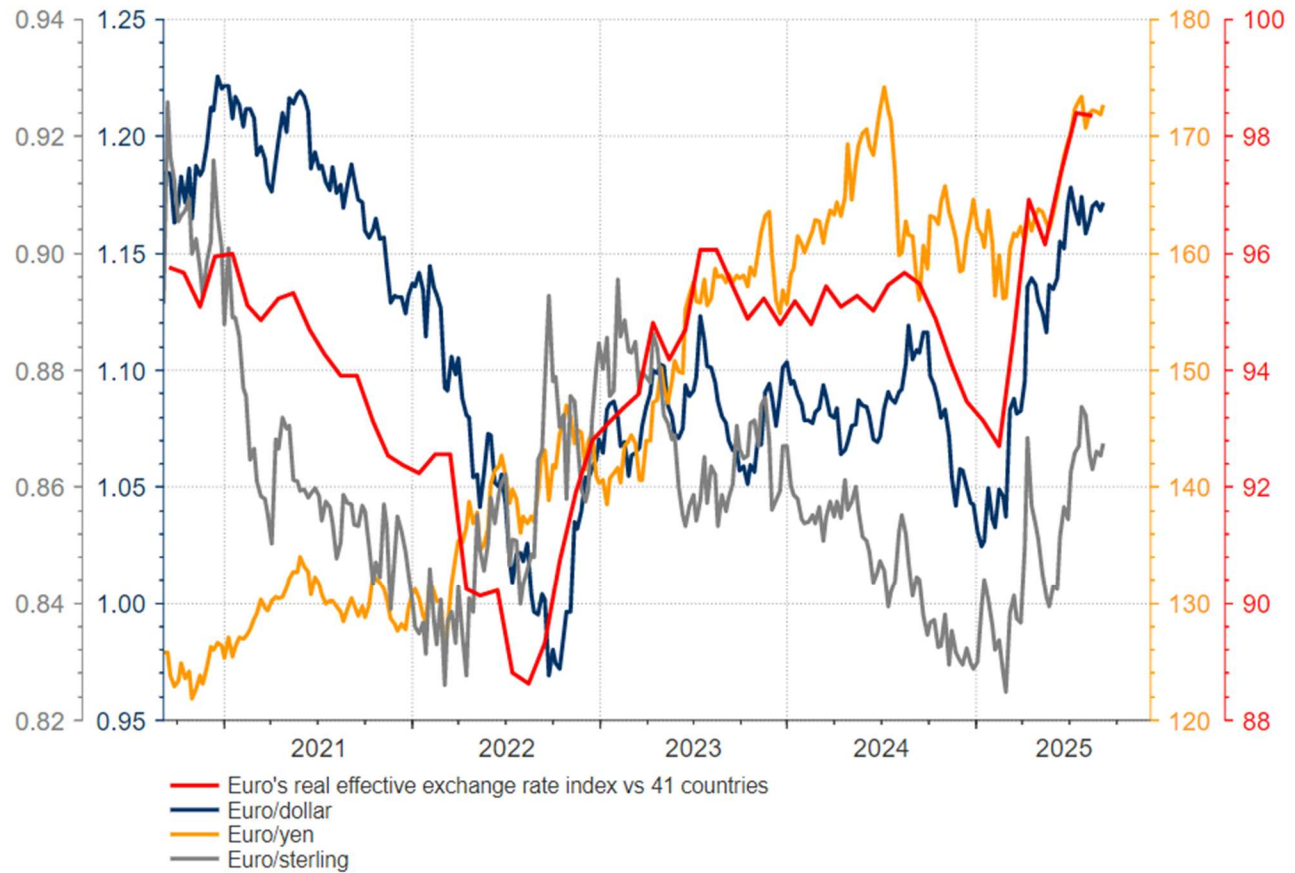
But direct political capture by any one of its members - along the lines being discussed in Washington, for example - currently seems far fetched. "In terms of the institution, the ECB is better protected than the Fed," Francesco Papadia, a former ECB official who is now a senior fellow at Bruegel, said last week. "What is happening in the United States could never happen in Europe." As a test of this notion, it continues to reduce its balance of bonds even as debt tensions rumble again in France.

MEDAL OR MILLSTONE?

The two main market consequences of messing with central bank independence are hot inflation expectations, steeper government yield curves and high long-term debt costs on the one hand and a weaker currency on the other. On those metrics, the jury appears out so far. Even though Washington is the center of the storm right now, European yield curves are actually steeper - even if nominal long-term yields are lower and inflation is already back at the ECB's 2% target. However, the euro has surged 13% against the dollar this year and could well be supercharged going forward - itself a dubious pleasure for a region with still meager economic growth and facing higher U.S. trade tariffs to boot. The Swiss National Bank's battle with franc strength and deflation is a far smaller but curious example.

Even though the ECB has embraced greater use of a "global euro" to help with the multiple heavy financing needs of the region, some of its officials have been uncomfortable about excessive euro appreciation beyond current levels. If the ECB were the last truly independent central bank left standing, it could ultimately be vulnerable to losing support at home if rival countries steal a march with a growth push and fiscal largesse. Whether greater market credibility can ultimately leave European voters better off than their peers in countries less finicky about central bank independence may then determine whether this adherence to rules is a badge of honor or a millstone.

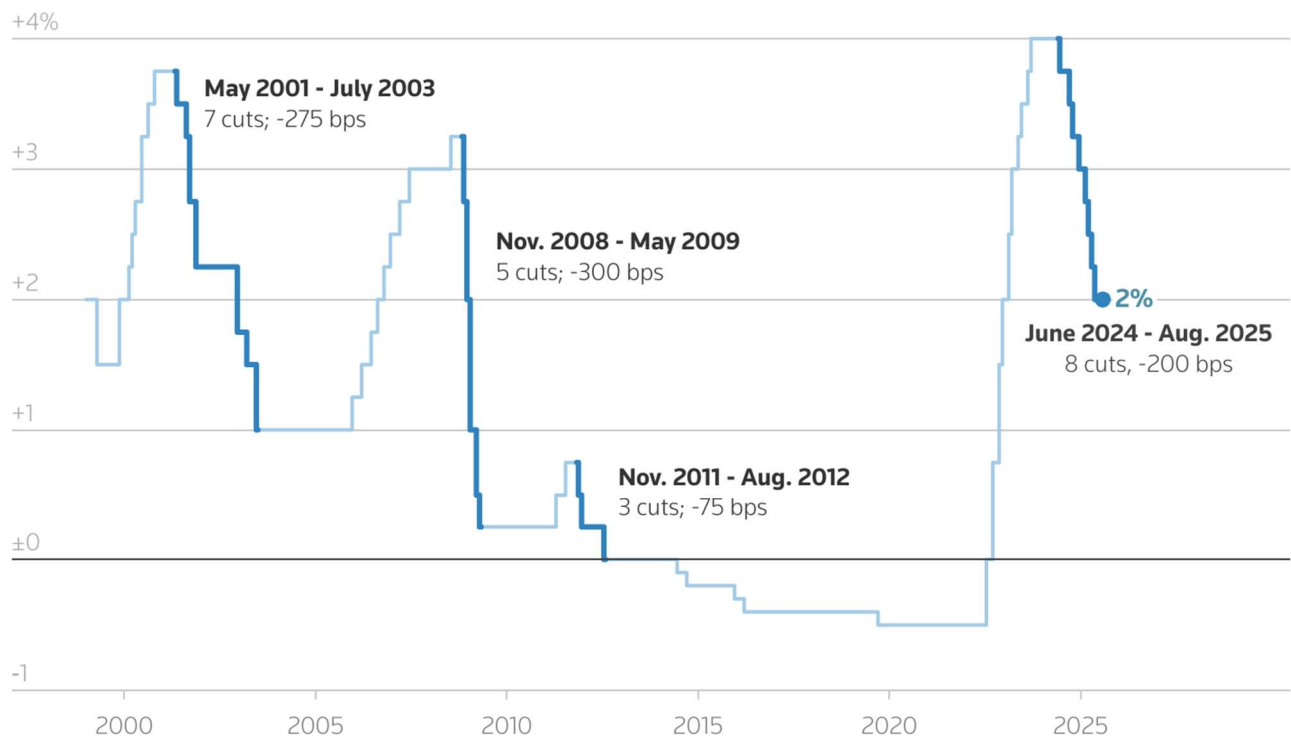
EURO'S REAL EXCHANGE RATE AT 11YR HIGHS



Source: LSEG Datastream

The ECB is all but certain to stay on hold in September

Markets see no chance of a rate cut on Thursday.



Source: LSEG Datastream | REUTERS, Sep. 4, 2025 | By Sumanta Sen