

## Japan Viewpoint

## US-Japan negotiations – potential policy and market implications

**Searching for common ground**

Japan's priority in US-Japan negotiations is to receive an exemption from or a reduction in the 24% reciprocal tariffs and a sectoral 25% tariff on auto, steel and aluminum. While concessions from Japan may be needed given the critical importance of the US-Japan security alliance for Japan's national security, the Japanese government would likely seek a balanced deal.

**Market implications**

A hard currency deal is too costly for Japan to accept and therefore, it is not our base case though uncertainty remains high. We expect Japan's commitment to more investment in the US, more imports from the US, and possibly more defense spending. Security/economic policy coordination could be discussed. We think USD/JPY has been oversold and the risk from US-Japan negotiations on USD/JPY is skewed to the upside.

**Investment in the US, including energy projects**

Japan would likely emphasize its record of investment and job creation, and plans to invest further, in the US. The Japanese government may go a step further to agree on investing in energy projects and importing more mineral fuels from the US. Such a deal would likely be seen as a tangible deal the US government may want, and the Japanese government could explain it to the public as diversification of energy procurement.

**Opening up Japan's selective markets**

We expect negotiations on goods trade to mainly focus on increasing Japan's imports of US agricultural products and autos. The US government has also zeroed in on these two categories when discussing non-tariff barriers it views as problematic. We expect Japan to lower tariff rates for agricultural products, which are currently higher than the US, and lift or relax import quotas, which could help ease food inflation in Japan. However, we think negotiations on auto non-tariff barriers are likely to remain fraught.

**Strengthened defense capability and policy coordination**

Japan could commit to increased defense spending. Strengthening the defense capability has been a trend over the past decade as Japan faces geopolitical pressure from China, the US's geopolitical rival. However, increasing defense spending more than currently planned is financially challenging. Japan may also be asked to increase security and economic policy coordination with the US in its China policy.

**Currency deal – market's biggest focus**

A hard currency deal with measures to realign USD/JPY is not our base case though uncertainty remains high. The Japanese government may view giving up autonomy in currency policy and monetary policy as too costly. A bilateral deal to realign USD/JPY could lead to one-sided JPY strength against majors. This means the US may have to spend significant amount of diplomatic capital for a hard currency deal, relative to other potential deals. A hard currency deal could lead to liquidation of US Treasuries by Japanese investors and jeopardize the US markets, leading to a spike in market volatilities.

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## Full tariffs on Japan to cause economic pain

The US announced it would impose a reciprocal tariff rate of 24% on Japan on Apr 2 and it announced on Apr 9 that the implementation of reciprocal tariffs would be postponed by 90 days except for tariffs on China. The US administration claims that when non-tariff barriers are included, Japan effectively imposes a 46% tariff on US imports, resulting in a 24% reciprocal tariff on imports from Japan (for the detail, see: [Japan Watch: US reciprocal tariff shock: A serious downside risk to growth and BoJ rate hikes 03 April 2025](#)).

Our economists view that such tariffs, if implemented, would be a major blow to Japan's economy with the degree of damage highly uncertain. Even with the unexpectedly harsh US reciprocal tariff proposal, we continue to think that the Japanese government is unlikely to introduce retaliatory tariffs. Prime Minister Shigeru Ishiba said on Apr 14 that while he would not declare Japan would not impose retaliatory tariffs, he does not think such measures would serve Japan's national interest given Japan's low self-sufficiency in food and energy and impacts on the upcoming negotiations. Most importantly, the US-Japan security alliance is critically important for Japan's national security. A hostile relationship with the US could increase Japan's geopolitical risk.

Instead, the Japanese government is likely to prioritize negotiating with the US as we discuss below, which would have market implications.

## US-Japan negotiations

US-Japan trade negotiations have started this week. Scott Bessent, the US Treasury Secretary who has been appointed as the US negotiator, said on April 8 that Japan was likely to get trade deal priority. Ryosei Akazawa, Japan's Economic Minister and negotiator, is said to meet Bessent this week. We do not expect anything concrete to come out of this round of meetings as this will be the first encounter between the two negotiators.

In February, PM Ishiba met President Trump and affirmed their "determination to pursue a golden age for US-Japan relations". While the joint statement did not spell out imbalance in bilateral trade, it had elements seen as potential issues the two countries may agree on in upcoming trade negotiations<sup>1</sup>.

### Search for common ground and aim for a deal by summer

Japan's primary goal would be to receive an exemption from or a reduction in the 24% reciprocal tariffs and a sectoral 25% tariff on auto, steel and aluminum. While concessions from Japan may be needed given the critical importance of US-Japan security alliance for Japan's national security, the Japanese government would seek a balanced deal. Exhibit 1 shows key issues and how we view merits and demerits for the Japanese government.

We expect an eventual deal would lead to reduced tariffs on Japan compared to what has been announced by now while we expect Japan's commitment to more investment in the US, more imports from the US, and possibly more defense spending. Security/economic policy coordination could also be discussed. A currency deal remains uncertain but we assume no hard currency deal involving measures to realign USD/JPY.

An early deal appears beneficial for both governments. The Japanese government would want a deal before the Upper House election, which is scheduled for July 22. An early deal could also benefit the US government after the market shock and as concern over stagflation looms.

<sup>1</sup> <https://www.mofa.go.jp/files/100791691.pdf>



As the market has been focusing on a potential currency deal, leading to realignment of USD/JPY, and remains long JPY, we think the risk is skewed to a higher USD/JPY (see the market section at the end).

Below, we explore potential issues of the trade negotiations with market implications.

#### **Exhibit 1: Potential issues of US-Japan negotiations (in order of higher merits for Japanese government relative to demerits in our view)**

Strict currency deal is too costly for Japan to accept

Issue	Merits for Japanese government	Demerits for Japanese government
More FDI in US	Status quo (likely to be achieved without any change as this is a structural trend)	
Opening up Japan's agricultural market	Lower food prices	Agricultural sector's opposition
Energy (LNG) deal	Diversification of energy procurement sources	Potentially higher unit costs
Eliminating non-tariff barriers in the auto market	Likely limited impact on imports of US cars Potentially lower auto tariff rate in return	Potential backlash from auto industry and public
Increasing defense spending more than currently planned (2% of GDP by FY27)	Stronger US-Japan security alliance to counter China	Fiscal constraint
Hard currency deal (USD/JPY realignment)	Prevent excessive JPY weakness	Undermined autonomy in currency and monetary policy

Source: BofA Global Research

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## **Investment to the US, including energy projects**

Japan is likely to emphasize its record of investment and job creation in the US and its willingness to invest in the US in the future. During the Ishiba-Trump summit in Feb, PM Ishiba “conveyed his willingness to cooperate together to elevate Japan’s investment in the U.S. to an unprecedented amount of one trillion dollars, and President Trump strongly welcomed such investments by Japanese companies.”<sup>2</sup>

The US has been the top destination of Japan’s FDI in recent years (Exhibit 2) and Japan has been the top country in the FDI balance in the US since 2019 with \$783bn outstanding as of 2023 (Exhibit 3). PM Ishiba’s “promise” to increase the investment balance to \$1tn appears a matter of time.

### **Energy projects as a tangible deal?**

The Japanese government may go a step further to agree on importing more mineral fuels from the US. The joint-statement in Feb noted “The two leaders also confirmed that they will cooperate to strengthen energy security between the two countries, including increasing exports of U.S. liquefied natural gas to Japan, in a mutually beneficial manner.” President Trump and Treasury Secretary Bessent both hinted that Japan’s participation in an Alaskan oil and gas project could be part of the deal.

According to the Nikkei, the cost is a concern for the Alaska LNG project<sup>3</sup>. That said, Japan still imported ¥548bn or 5.7mn tons of LNG (8.6% of all LNG imports) from Russia in 2024 (Exhibit 4). The Alaskan project targets to produce 20mn tons of gas per year<sup>4</sup>. There may be scope for Japan to diversify its LNG procurement. The government could provide private firms participating in such projects with financial supports.

Such a deal would be seen as a tangible deal the US government may want and the Japanese government can explain it to public as a diversification of energy sources.

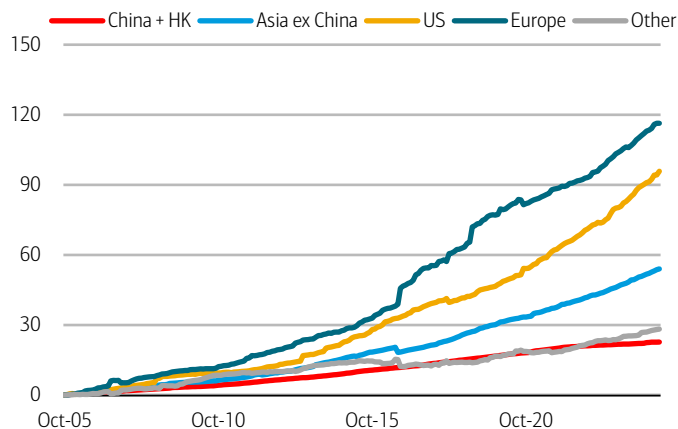
<sup>2</sup> [https://www.japan.go.jp/kizuna/2025/03/japan-us\\_alliance\\_to\\_new\\_heights.html](https://www.japan.go.jp/kizuna/2025/03/japan-us_alliance_to_new_heights.html)

<sup>3</sup> <https://www.nikkei.com/article/DGXZQOGN0931S0Z00C25A2000000/>

<sup>4</sup> <https://www.reuters.com/business/energy/alaska-governor-brief-trump-asia-gas-push-tariffs-bite-2025-03-28/>

**Exhibit 2: Japan cumulative FDI by destination (¥tn)**

Japan's investment in the US has been rising in the past decade

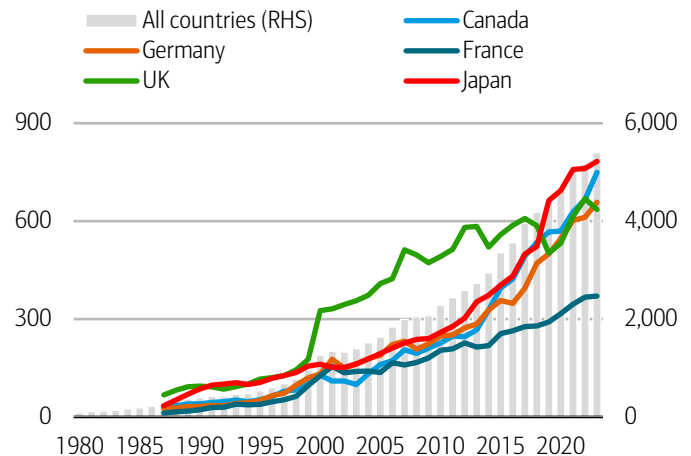


Source: BofA Global Research, Haver

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**Exhibit 3: FDI outstanding in the US by country (\$bn)**

Japan ranks as the biggest foreign direct investor in the US

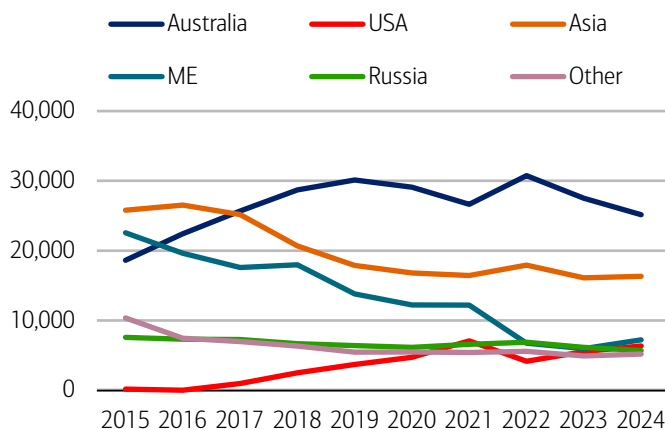


Source: BofA Global Research, Haver

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**Exhibit 4: Japan annual LNG imports by region (thousand tons)**

Japan still imports LNG from Russia

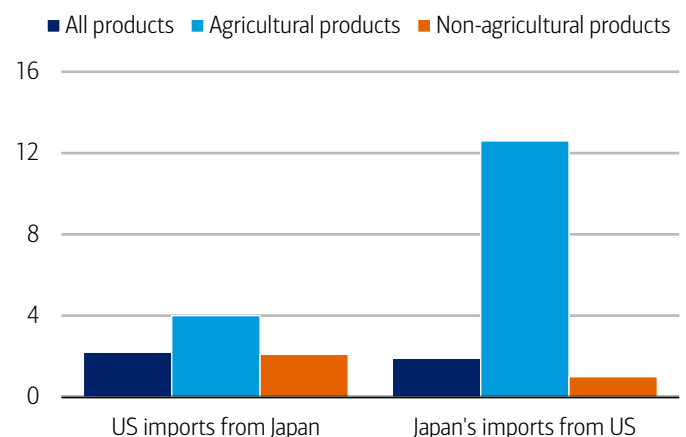


Source: BofA Global Research, Ministry of Finance

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**Exhibit 5: Bilateral tariff rate between US and Japan (%)**

Japan's agricultural tariffs on US products stand out



Source: BofA Global Research, WTO

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**Opening up Japan's selective markets**

We expect negotiations on goods trade (ex. energy) to mainly focus on increasing Japan's imports of US agricultural products and autos. The US government has also zeroed in on these two categories when discussing non-tariff barriers it views as problematic (Exhibit 6).



**Exhibit 6: Japan's problematic non-tariff barriers cited by USTR**

Food and auto in focus

Category	Non-tariff barrier
Fish and seafood	Import quotas, time-consuming import procedures
Rice	Highly regulated, nontransparent distribution process
Wheat	Government has state trading entity for all wheat imports
Pork	Sets minimum import price (gate price mechanism)
Potatoes	US potato exports to Japan limited to chipping potatoes (table-stock potatoes banned)
Beef	Strict BSE safety standards
Express delivery	Customs procedures are complex and time-consuming
Digital platforms	Foreign companies subject to additional regulations and scrutiny that do not apply to most Japanese companies
Automotive	Excessively strict safety and environmental standards, unique certification program (model certification), lack of access to sales networks, unfair treatment regarding EV subsidies and charging stations, tax and regulatory incentives for minivehicles
Medical devices and pharmaceuticals	Lack of transparency and predictability on NHI reimbursement price setting, artificial government price curbs
Nutritional supplements/quasi-drugs	Complex, time-consuming approval/authorization processes

Source: BofA Global Research, USTR

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**Deal on rice and other agricultural products amid high food inflation?**

We expect Japan to lower tariff rates for agricultural products, which are currently higher than the US (Exhibit 5), and lift or relax import quotas. The final agreement from the 2019-2020 US-Japan trade negotiations also included commitments by Japan to reduce tariffs to around the same level applied under the TPP (Trans-Pacific Partnership agreement) and to improve market access.

While rice was excluded from these negotiations, the Trump administration has recently criticized Japan's unduly high tariffs on rice, and we think the Japanese government could propose expanding its tariff-free "minimum access rice" quota (currently 770,000MT per year) and reducing the volume-based tax (¥341/kg) on rice outside this quota. The recent jump in domestic rice prices (in contrast to 2019-2020) should also lower the hurdle to increasing imports (see: [Japan Viewpoint: Structural supply-side issues to prolong food inflation 18 March 2025](#)).

**Difficulty around auto negotiations**

However, the US's total 2024 rice exports were only around ¥400bn, and even including beef and pork the figure is a few trillion yen; unless Japan buys 100% of US agricultural exports the US's ¥8.6tn trade deficit is unlikely to shrink appreciably.

We therefore think negotiations will focus mainly on autos, which account for ¥5.9tn of the US's trade deficit with Japan (¥7.0tn for the broader transportation equipment category). However, it will be difficult to change the uniform safety standards, certification programs, and sales network requirements that Japan applies to all cars sold domestically.

If Japan's response is limited to gradually easing preferential regulations on domestic cars and introducing purchase subsidies for US-made vehicles, this would not be enough to substantially increase US imports. We therefore think negotiations on auto non-tariff barriers are likely to remain fraught.

**Strengthening defense capability and policy coordination**

Japan could commit to increased defense spending, which has been a trend over the past decade as Japan faces geopolitical pressure from China. Stronger Japanese defense capability should be of interest for both Japan and the US.

The question is how much. The Trump administration has been arguing that US allies should pay more as they see the framework as unbalanced. The Ishiba-Trump joint statement noted the US "welcomed Japan's commitment, underpinned by a favorable trend of its defense budget increase, to building capabilities by FY 2027 to consolidate its primary responsibility for defending Japan, and, building on this significant foundation, to fundamentally reinforcing its defense capabilities beyond FY 2027."



In 2022, the Japanese government decided to increase Japan's defense spending to 2% of GDP or ¥11tn by FY27 (2% of GDP would be ¥12tn using today's GDP) from slightly above 1% in FY22 or ¥5.9tn (Exhibit 7). Elbridge Colby, who has been confirmed as Undersecretary of Defense for policy by the US Senate, said "Japan should be spending at least 3% of GDP on defense as soon as possible" in a written statement at a Senate confirmation hearing in March.

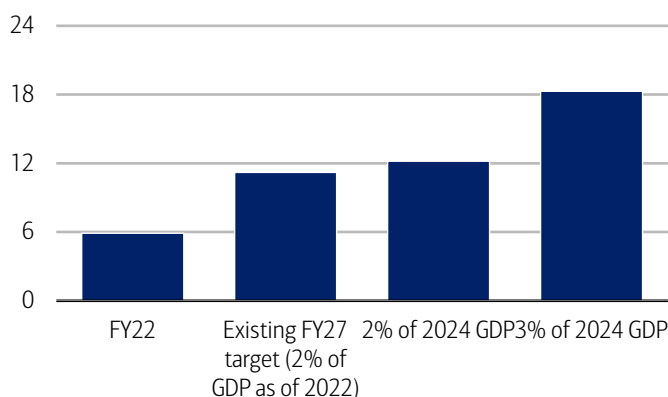
Increasing defense spending to 3% of GDP will likely be challenging as the Japanese government has as yet been unable to fully secure financing even for the current 2% of GDP goal. Any increase in defense spending is likely to constrain Japan's public finances, and lead to more imports from the US, with our economists estimating 20% of additional spending to be stent on imports (¥1.2tn using today's GDP). For details on this issue, see: [Japan Capital Goods: Defense spending back in spotlight 10 March 2025](#).

### Security and economic policy coordination

On top of increasing defense capability, as the geopolitical rivalry between the US and China continues, Japan may be asked to increase security and economic policy coordination with the US. Measures could include cooperation in technology development, tighter export controls, and supply chain diversification and friend-shoring to reduce dependence on China.

#### Exhibit 7: Japan's defense spending – current vs (potential) targets (¥tn)

Increasing defense spending to 3% of GDP would constrain Japan's budget



Source: BofA Global Research

See: [Japan Capital Goods: Defense spending back in spotlight 10 March 2025](#)

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### Currency deal – market's biggest focus

How Japan and the US can agree on currency issues appears to be the biggest concern and uncertainty for the market. President Trump has criticized the yen's cheapness in the past and Treasury Secretary Bessent recently noted "Japan remains among America's closest allies, and I look forward to our upcoming productive engagement regarding tariffs, non-tariff trade barriers, currency issues, and government subsidies".

During the first Trump presidency, the US government intended to "ensure that Japan avoids manipulating exchange rates in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage."<sup>5</sup> However, no currency clause made it to the US-Japan trade deal at the end<sup>6</sup>. ([Japan Watch: US-Japan trade deal: signed, sealed, and \(almost\) delivered 26 September 2019](#)).

<sup>5</sup> [https://ustr.gov/sites/default/files/2018.12.21\\_Summary\\_of\\_U.S.-Japan\\_Negotiating\\_Objectives.pdf](https://ustr.gov/sites/default/files/2018.12.21_Summary_of_U.S.-Japan_Negotiating_Objectives.pdf)

<sup>6</sup> <https://www.mofa.go.jp/mofaj/files/000527401.pdf>

There is speculation in the market that a currency deal could constrain the BoJ's policy and lead to faster rate hikes by the BoJ. However, a currency deal that directly constrains Japan's currency policy or monetary policy is unlikely, at least in the bilateral trade negotiations, in our view.

### **Hard currency deal too costly for Japan...**

The Japanese government would likely view giving up autonomy in currency policy and monetary policy as too costly. Japan suffered from a deflationary economic regime for nearly 30 years and the BoJ appears to be finally nearing to achieve reanchoring of inflation expectations. Since the 1980s, Japan's fiscal condition has significantly worsened and Japan would have limited scope for fiscal spending to compensate for a stronger currency rate or tighter monetary policy. Moreover, the Plaza Accord of 1985 has been often cited as one of the triggers for Japan's stock market and real estate bubbles in the late 1980s/early 1990s, and the following economic stagnation.

The Japanese government may view agreeing to a realignment of USD/JPY in a bilateral agreement too risky as it could lead to broad JPY strength, not just against USD.

This means the US would likely have to spend a significant amount of diplomatic capital for a hard bilateral currency deal relative to other potential deals mentioned above.

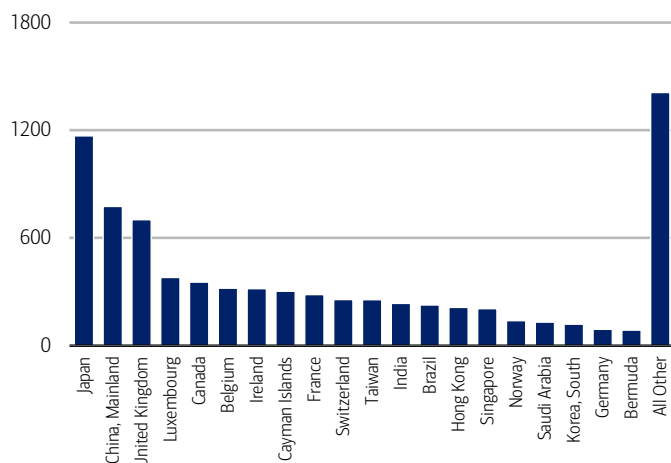
### **... and could lead to unwinding of UST by Japanese investors**

A hard currency deal could jeopardize the US markets as well. Japan is the biggest foreign holder of US Treasuries with over \$1tn UST holdings (Exhibit 8) and \$943bn of Japan's \$1.3tn foreign reserves is held in securities, which are thought to be mainly US Treasuries and US agency securities (Exhibit 9, Exhibit 8). If the government needs to strengthen JPY against USD by selling its reserves, it would involve selling US Treasuries. Such actions could urge Japanese private investors to unwind US Treasuries, leading to a spike in volatilities, and possibly a sharp sell-off in USD and US Treasuries. A currency deal could also be seen as less tangible than deals on specific products, such as LNG, rice and meat.

The Japanese government may want to limit the currency deal to the one similar to the USMCA's (United States-Mexico-Canada Agreement, 2020), which does not go much beyond what has been agreed by the G7 and G20. Japan could also commit to preventing the yen's excessive decline by FX intervention, which it has done since 2022, though we do not expect such a commitment would be made official or written into an agreement.

**Exhibit 8: Major Foreign Holders of Treasury Securities (\$bn, end-Feb, US TIC data)**

Japan is the biggest foreign holder of US Treasuries

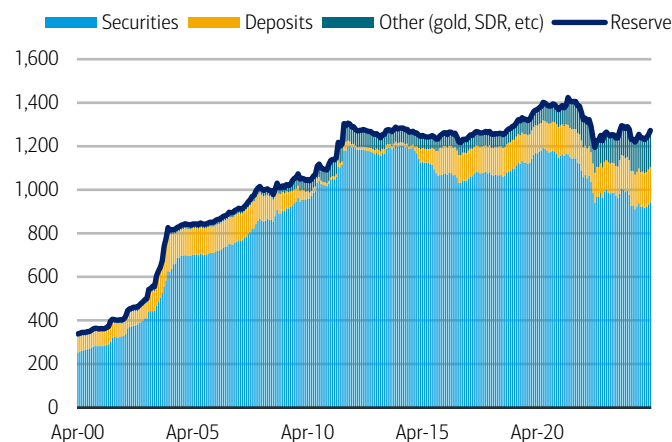


Source: US Treasury

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**Exhibit 9: Japan foreign reserves (\$bn)**

Mostly held in securities



Source: BofA Global Research, Haver

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**BoJ to remain cautious**

Given elevated economic and policy uncertainty, it will likely be extremely challenging for the BoJ to accurately assess the economic and inflation outlook based solely on economic data for March and April. The BoJ will therefore need to carefully evaluate domestic and overseas data (particularly from the US) from May onward to assess the negative impact of tariffs and reflect this in their outlook for Japan's economy and prices.

**BoJ policy unlikely to be a negotiation tool**

As we noted above, we do not think the government will let BoJ policy be part of the deal and instead they would try to separate the BoJ's independence from diplomacy. If the BoJ is urged to hike to defend the yen and appeal to the US government, the BoJ would lose its credibility as an independent central bank and policy predictability may decline greatly. It could cause increased market volatility and unwarranted tightening in financial conditions, which may also be politically too costly for the Ishiba administration.

**Risk of no hike or even cuts, rather than faster hikes**

Of course, we cannot ignore underlying pressure from the US government, which may increase the government and the BoJ's sensitivity to the currency market in future policy decisions when the yen is weakening. However, we think the risk we have to consider now is the BoJ's policy bias becoming more neutral, or turning to an easing one if downside economic pressure from tariffs build.

**Market implications****Rates – watch currency deal and government's fiscal response**

For the rates market, key issues are a currency deal and the government's fiscal response. Some market participants wonder if a currency deal would lead to faster BoJ rate hikes. We think this is unlikely. The BoJ is likely to carefully assess the impact of US trade policies. A quick deal should lead to a revival of rate hike expectations for 2025.

Another issue is the government's fiscal policy. It has been reported that the government has decided to not compile a supplementary budget at this stage. However, pressure may arise if Japan's economy stagnates before the Upper House election in





July. US-Japan negotiations can also lead to increased fiscal spending in the future, for example, by increasing defense expenditure.

### FX – USD/JPY has been oversold relative to risks

A positive scenario for USD/JPY is that the US and Japan reach an agreement relatively soon in 2Q25 without a hard currency deal. The two countries could find common ground outside currency issues as we discussed above, which would involve measures leading to more capital flows from Japan to the US. An early deal may be preferred by both governments from a perspective of political scheduling and current economic and market conditions.

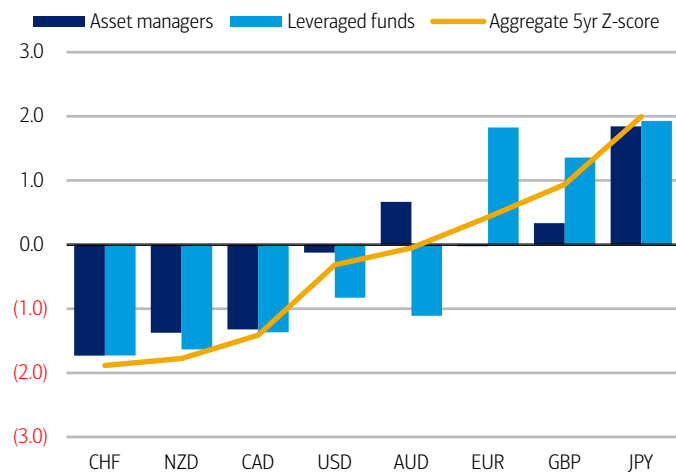
A negative scenario for USD/JPY is that the US's priority on realigning USD/JPY's level is high. In this case, negotiations are likely to take time, passing the 90-day grace period. If the deal has not been struck, it could become a key theme for the Upper House election in July, increasing market volatility.

USD/JPY has been under pressure this month as the market reevaluates USD in light of elevated US trade policy uncertainties. By now, we think USD/JPY has been oversold, as exemplified by biggest JPY long position by asset managers and leveraged funds at CME (Exhibit 10). Our base case for a trade deal, which would lead to more capital flows from Japan to the US and which does not involve any hard currency deal, would be positive for USD/JPY.

While credibility of USD has likely been diminished after April 2, we expect Japanese structural outflows to the US continue to some extent, although some may be diverted to other regions, such as Europe. The trend of outward investment by Japanese retail investors has not stalled under the recent market turmoil. We expect Japanese firms, which had accelerated outward M&A activity in 1Q25, to invest abroad again once a trade deal is struck between the US and Japan and policy uncertainty declines. We still think JPY's declining trend is stronger than USD's potential one. We remain long EUR/JPY (see: [Japan Rates and FX Viewpoint: JPY vs JGB – JPY still in the driving seat 18 February 2025](#)).

#### Exhibit 10: CFTC FX futures positioning (5-year z-score)

Market is long JPY

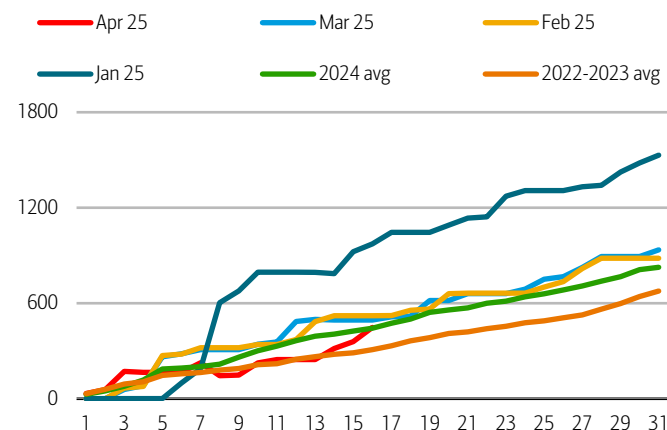


Source: BofA Global Research, Bloomberg

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#### Exhibit 11: Estimated net (average) cumulative inflow to major foreign asset Toshins by month (¥bn)

The pace of outward investment has slowed this month, but has not reversed



Source: BofA Global Research, Bloomberg

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