Daiwa's View

May price indices in Japan and US confirmed a situation roughly in line with optimal tariff theory

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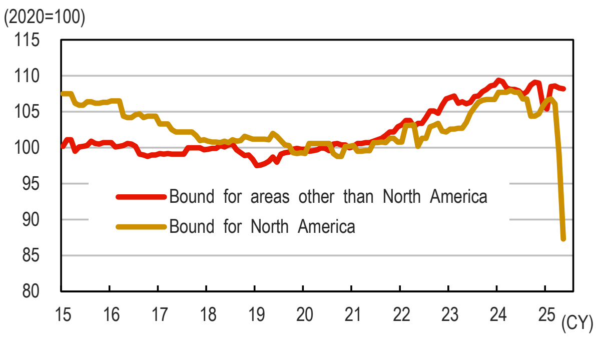
- While impact of tariffs on US CPI was smaller than expected, BOJ's Corporate Goods Price Index revealed that Japanese firms are absorbing tariff costs through price reductions
- The situation is roughly in line with optimal tariff theory, and, if this trend continues, negative impact of tariff policies on US economy may be much smaller than economists expected
- Meanwhile, as this theory implies greater downward pressure on exporting nations than projected, it may constrain additional rate hikes by BOJ

In our 9 May report entitled "Melting ice cube," we pointed out that US Treasury Secretary Scott Bessent's tariff policy is based on microeconomic theory, and that if optimal import tariffs allow "large countries" to raise tariff income while extracting improved terms of trade, import tariffs could increase social surpluses, while suppressing domestic price growth. When we combine the May BOJ Corporate Goods Price Index (CGPI) data and the May US CPI data, both of which were released yesterday, a picture emerges that is indeed in line with such a situation.

Japanese companies absorbing tariff costs through price reductions

The BOJ's May CGPI data showed that export prices on a contract currency basis fell by 0.9% m/m (down 1.4% y/y). The largest contributor to the m/m drop was "transportation equipment," which recorded a significant drop of 0.65%. As a reference, the BOJ also releases export price indexes for passenger cars, based on those bound for North America and those bound for areas other than North America. According to these figures, the North America-bound index fell by 6.5% m/m in April and 12.0% in May, posting a cumulative 18.5% plunge over those two months. Since this index includes exports to Canada, it can be assumed that the absorption rate for the US market was nearly 100%.

Export Price Indexes for Passenger Cars (contract currency basis)

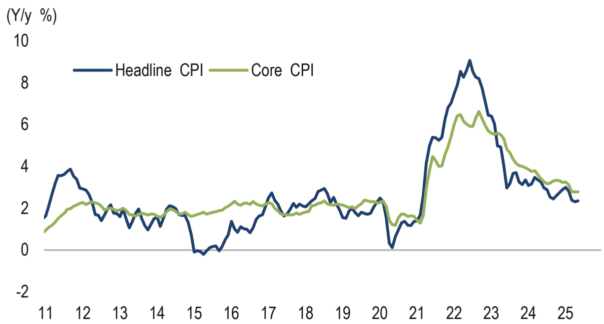


Source: BOJ; compiled by Daiwa.

May US CPI readings were lower than projected

The May US CPI data, released last night, came in below market expectations, revealing that the rise in consumer prices caused by increased tariffs was more suppressed than initially anticipated.

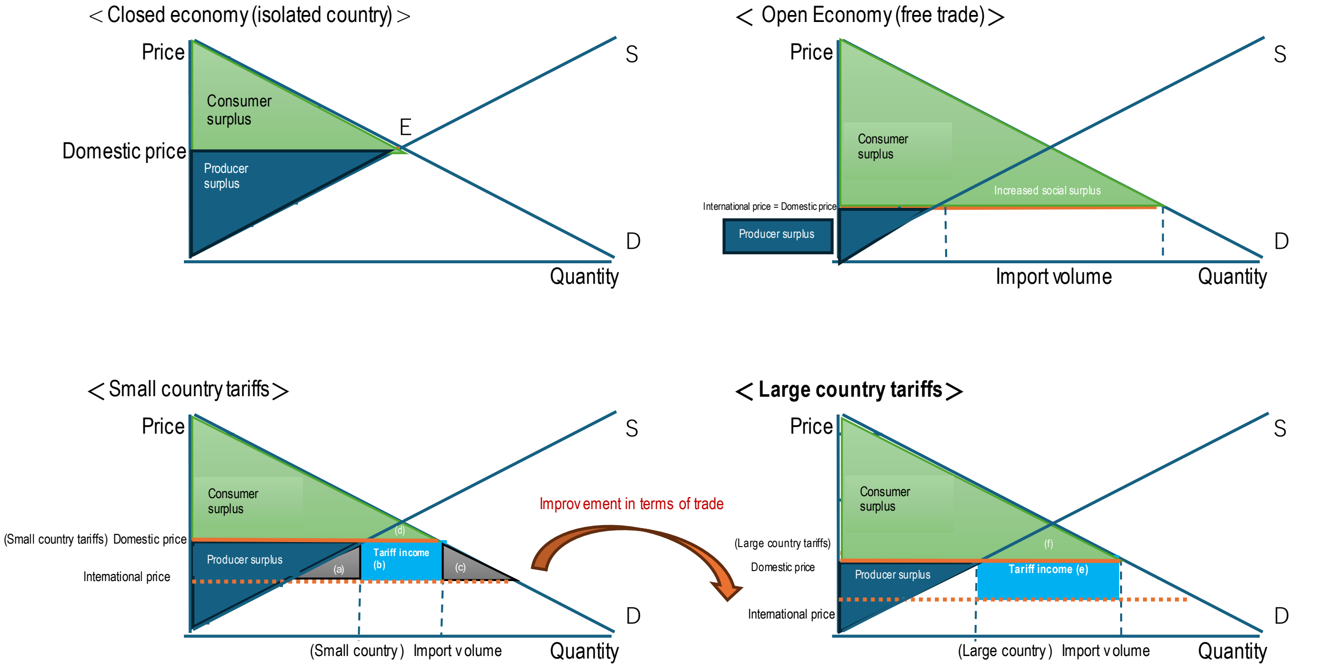
US CPI (headline, core)



Source: US Labor Department; compiled by Daiwa.

Of course, the May price data for Japan and the US may still include “menu costs,” so it is premature to draw definitive conclusions from just the April and May data. (For example, automakers might keep prices unchanged for current models, but reflect cost increases when changing models.) However, the combination of these two price indices are currently roughly in line with the scenario based on the optimal tariff theory—in which exporters to large countries absorb a part of the cost of tariffs through price reductions—envisioned by Mr. Bessent.

Tariffs and Price Determination in Microeconomic Theory (closed and open economies, small and large countries)



Source: Compiled by Daiwa.

Will this constrain BOJ rate hikes?

Fed Governor Christopher Waller commented on the impact of tariffs in his speech the other day, pointing out, “I suspect the tariff cost will not be fully passed through and, instead, the burden will be distributed something like 1/3, 1/3, and 1/3 among consumers, importers and exporters.” If the eventual impact were close to what optimal tariff theory suggests it would be, the negative impact of tariff policy on the US economy would be less than expected by the market and economists, which might lead to a full-fledged reversal of the “triple sell-offs” since April. On the other hand, this means greater downward pressure on economies in exporting nations (incl. Japan) than previously anticipated, which can be regarded as a factor that will constrain additional rate hikes by the BOJ.

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