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Next up: Tariff talks

- LDP-Komeito coalition's Upper House election loss undoubtedly severe, but not as bad as feared
- Focus shifting to tariff talks; risk US could pursue tough line on tariffs this time
- Key point is Japanese firms' ability to pass through cost of tariffs to customers

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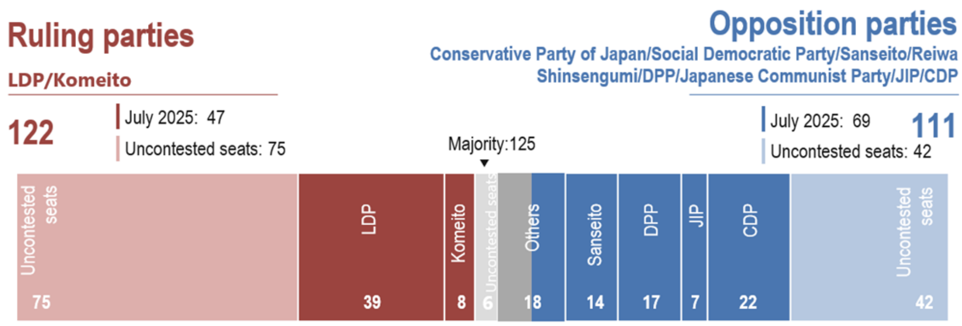
LDP/Komeito coalition's massive Upper House election loss not as bad as expected

Japan's ruling Liberal Democratic Party (LDP)/Komeito coalition suffered a heavy loss in the 27th Upper House elections on 20 July, winning just 47 seats (LDP 39, Komeito 8). It failed to reach its 50-seat target, and even including the 75 seats that were not up for reelection, the coalition is now three seats short of the 125 it needed to retain its majority (Chart 1). The Constitutional Democratic Party (CDP) won an unchanged 22 seats while the Democratic Party for the People (DPP) won 17 and Sanseito 14. The Japan Innovation Party (JIP) added one seat for a total of seven.

The LDP-Komeito coalition failed to retain its majority, which was the low target it had committed to achieving, but protest votes against the government also did not flow to the CDP, the leading opposition party. Voters seeking to express their dissatisfaction with the LDP bypassed the CDP and instead voted for the DPP and Sanseito. However, while the LDP-Komeito coalition undoubtedly suffered a substantial loss, the market views the result as not as bad as feared.

The *Asahi Shimbun*'s final election poll on 13-14 July indeed showed the LDP winning only around 34 seats and Komeito around nine. Given media reports that the DPP was within range of its target of at least 16 seats and Sanseito could win around seven single-member constituencies and around eight proportional representation constituencies, the outcome was broadly as expected.

Chart 1: Results of 27th Upper House Elections and Seat Breakdown by Party



	LDP	Komeito	Independents	Other parties	Conservative Party of Japan	Social Democratic Party	Sanseito	Reiwa	DPP	Japanese Communist Party	JIP	CDP
Results of Jul 2025 election	101	21	13	2	2	2	15	6	22	7	19	38
Before official announcement	114	27	12	2	0	2	2	5	9	11	17	38

Source: House of Councilors, Nikkei, Asahi Shimbun; compiled by Daiwa.

Responding to the election result, Prime Minister Shigeru Ishiba stated at a press conference on the afternoon of 21 July that he intends to stay on as PM: "My top priority at this point is keeping the central government running. While I keenly feel my responsibility for the election loss, I must discharge my responsibility to the country and its citizens as leader of Japan's largest party and avoid political deadlock".

The LDP's substantial loss of seats in the Upper House election follows defeats in the October 2024 Lower House race and June 2025 Tokyo Metropolitan Assembly elections, and represents a third straight loss in a key election for PM Ishiba. While his decision to stay on is unsurprisingly beginning to draw criticism from within the LDP, we think his goal may be to avoid creating a political vacuum as the 1 August deadline for US reciprocal tariffs approaches, then make a graceful exit after concluding the US-Japan trade talks. If Japan fails to make a deal with the US or Ishiba remains after one is struck, we would expect a more aggressive move to replace him.

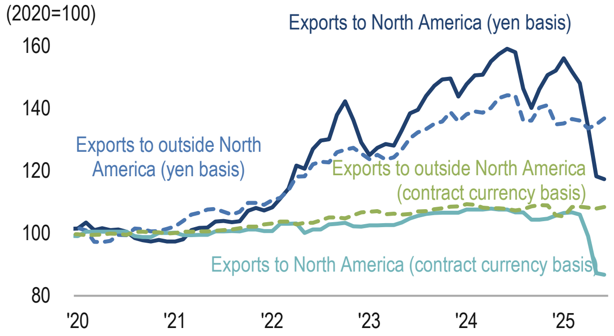
Can Japanese firms pass through cost of tariffs?

Either way, now that the Upper House election is over the focus will shift to US-Japan tariff negotiations. PM Ishiba has committed to reaching a deal that serves the interests of both Japan and the US and aiming for the key 1 August deadline, and has stated that he intends to hold direct discussions with President Trump as soon as possible with the aim of delivering tangible results. On 21 July, Japan's chief negotiator, Minister of Economic Revitalization Ryosei Akazawa, departed for Washington to hold an eighth round of talks with US Cabinet members. According to government sources, the US is currently examining Japan's proposal to reduce its trade surplus by investing heavily in the US and increasing imports of US products.

The timing of Japan's Upper House election undeniably hampered the trade talks, and we think negotiations will now ramp up in earnest; however, we will be watching whether an agreement can be reached by 1 August given that only 10 days remain. Canada's prime minister Mark Carney, who had previously aimed to eliminate US tariffs, indicated on 15 July that he had switched to the more pragmatic goal of reducing tariffs, arguing that "there’s not much evidence at the moment — from the deals, agreements and negotiations with the Americans for any country or any jurisdiction — to get a deal without tariffs". Japan is working hard on getting the US to eliminate or lower tariffs on autos, but an undue focus only on autos could result in it being subjected to both the 10% basic reciprocal tariff rate and failing to have the additional tariffs reduced, leaving it with a 25% duty on all its US exports. The market retains the view that Trump Always Chickens Out (TACO), but this downplays the threat from tariffs, and we therefore think this may be the point where the US pursues a tough line on imposing tariffs.

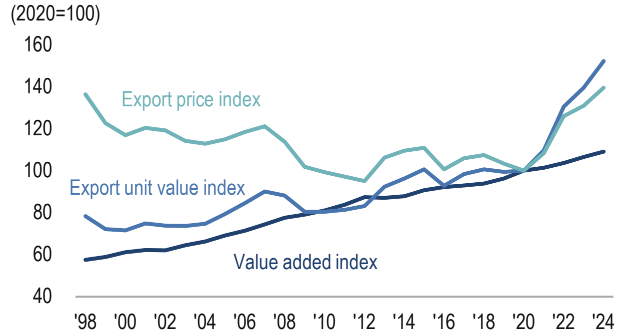
The outcome of tariff negotiations will naturally be important, but corporate price-setting behavior after tariffs are finalized will be key. Specifically, we focus on whether Japanese firms are able to raise export prices by the proper amount. For instance, automakers have thus far absorbed the cost of tariffs and cut export prices to avoid raising sales prices in the US. According to the June corporate goods price index (CGPI), passenger vehicle export prices to North America were down 18.2% on a contract currency basis and 20.8% on a yen basis compared with March, immediately prior to the increase in auto tariffs (Chart 2). The decline in yen terms was partly due to forex movements (a stronger yen), but prices also fell on a contract currency basis, reflecting a major impact from exporters' price cuts.

Chart 2: Export Price Index (passenger vehicles)



Source: BOJ: compiled by Daiwa.

Chart 3: Value Added Index



Source: MOF, BOJ: compiled by Daiwa.
Note: While the Ministry of Finance (MOF) export unit value index includes the increase in goods' value added, the export price index adjusts for the increase in goods' value added; this makes it possible to calculate changes in goods' value added by comparing the two.

If Japanese firms are unable to raise export prices, this would increase downward pressure on the yen via two channels. The first is worsening supply/demand caused by a growing trade deficit; the second is receding expectations for Bank of Japan (BOJ) rate hikes. As noted, absorbing the cost of tariffs by lowering export prices would result in a decline in export value and a shrinking trade surplus (a larger trade deficit). A negative impact on the Japanese economy from worsening terms of trade would naturally cause the BOJ to be cautious about rate hikes out of consideration for the economy, which would make yields more likely to fall and JPY to be sold.

2024 trade statistics indicate that the value of passenger vehicle exports to the US was Y5.9tn; assuming no change in export volume, a 20% decline in prices would depress export value by Y1.2tn. Applying a 25% rate to Japan's Y21.3tn in total exports to the US (50% for steel and aluminum) would result in Y5.4tn in tariffs, while a 10% rate (25% for autos, 50% for steel and aluminum) would result in Y3.2tn; if Japanese companies absorbed the entire cost of these tariffs, this would result in a commensurate decline in export value. Assuming a roughly Y1 impact on JPY from every Y1tn in tariffs, we would expect tariffs to weaken the yen by between Y1 and just over Y5.

However, Japanese companies are unlikely to shoulder the entire cost of tariffs, as evidenced by automakers' July price hikes in the US. They are also refraining from aggressively passing through tariff costs while tariff talks are underway, and we think many will opt to raise prices once a deal is reached. However, companies will still need to lower export prices to compensate for the percentage of tariff costs that they are unable to pass through, which will depress their terms of trade (export price divided by import price), weakening corporate earnings and reducing jobs and incomes, with a negative impact on the entire Japanese economy.

We therefore think Japanese firms should aggressively pass on higher tariff costs. While price hikes could of course erode price competitiveness and reduce export volume, the price elasticity of Japan's exports has been trending downward since the late 2000s, making demand less responsive to price movements. This reflects Japanese firms' progress with increasing the value added of their exports, and is a factor behind the lack of growth in export volume despite the yen's recent weakness (Chart 3). If our analysis is correct, we would not expect a major decline in export volume even if Japanese firms raise prices provided the US economy remains firm.

Another key point is support for the US economy from the use of additional tariffs to fund tax cuts. If Japanese exporters raise prices to reflect the cost of tariffs, US importers and households that benefit from the tax cuts will bear the cost. However, if exporters absorb the cost of tariffs Japan would bear all the downside while the US enjoys all the upside, and the widening economic gap between Japan and the US would likely cause the dollar to strengthen versus the yen. We think Japanese firms' efforts to overcome Trump tariffs should focus on wage hikes and other means for distributing profits within Japan, rather than on lightening the load for US citizens.

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