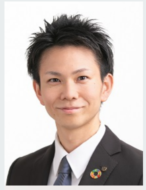
Daiwa's Economic View

Front-loading rate hikes and the turning point for "achieving 2% inflation target"

- Next rate hike expected in Apr-Jun 2026, with a semiannual pace thereafter
- A hawkish turning point on achieving the price target

FICC Research Dept.



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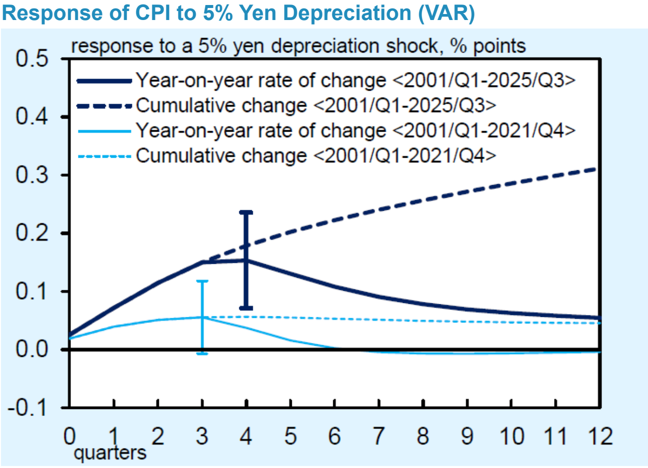
Next rate hike expected in Apr-Jun 2026, terminal rate forecast at 1.5%

At the January Monetary Policy Meeting (MPM), in addition to a rate hike proposal from board member Hajime Takata, an improved economic assessment and a hawkish price outlook were presented. At the regular press conference after the meeting, Governor Kazuo Ueda stated that regarding the impact of rate hikes to date, the BOJ "should not wait for the effects to appear in the final data," adding, "it is true that we have a certain degree of interest in the price pass-through in April."

These press conference remarks suggest an intention to promptly grasp initial data movements through the BOJ Tankan (Mar survey) due out on 1 April and hearing information based on the report from the branch managers' meeting in early April. Furthermore, if confirming the April price pass-through via price indices, the trend at the beginning of the fiscal year would be checked with CPI in the ward-area of Tokyo due out on 1 May. Taken together, these points suggest the timing of the next rate hike assumed by the BOJ is being brought forward from its previous pace of once every six months.

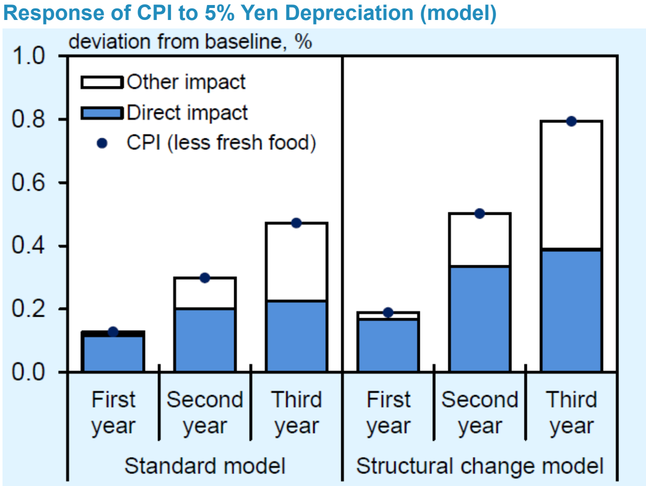
The background for front-loading the rate hike includes concerns about upward price pressure stemming from fiscal expansion and yen depreciation. Notably, according to Box 3, "Pass-Through of Import Price Increases to Domestic Prices," in *the January Outlook for Economic Activity and Prices*, the direct impact of yen depreciation on the CPI is gradually reflected over about one year, and secondary spillover effects can cause the currency's impact to remain apparent for around three years. In other words, exchange rate fluctuations are not limited to a temporary cost-push; they can have medium- to long-term effects through price stickiness, prompting the BOJ to monitor this trend more closely than ever.

Response of CPI to 5% Yen Depreciation (VAR)



Source: Reprinted from BOJ materials.

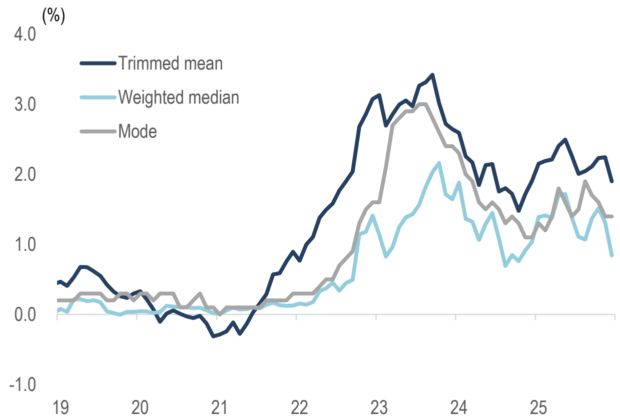
Response of CPI to 5% Yen Depreciation (model)



Source: Reprinted from BOJ materials.

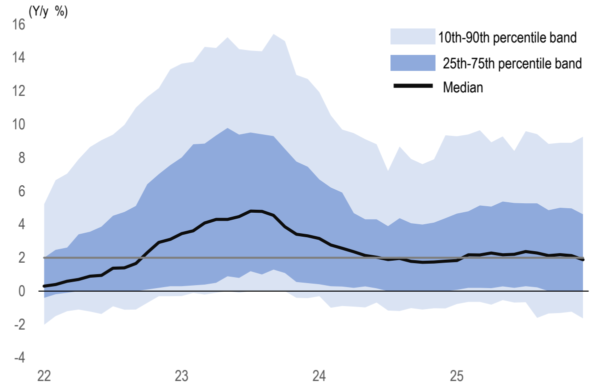
That said, looking at indicators for capturing underlying inflation and the simple median of CPI, both currently show a decline in the rate of increase, making it clear that current prices are in a disinflationary trend. Under these circumstances, our view remains unchanged that, partly due to the effects of government measures, core CPI will fall below 2% y/y in February 2026. However, the dual upward price pressures from fiscal expansion and yen depreciation could lead to a broader price pass-through with a time lag, and it appears that interest is shifting from the current disinflation to the possibility of future price pass-through.

Measures of Underlying Inflation



Source: BOJ; compiled by Daiwa.

Simple Median of Nationwide CPI



Source: Ministry of Internal Affairs and Communications; compiled by Daiwa.

Meanwhile, after the January MPM, media reports of a coordinated Japan-US rate check caused the USD/JPY rate to fall to the Y152 level for now. Under these conditions, it can be said that the upside risk from currency fluctuations has decreased. On the other hand, the background of the weak yen is presumed to be inflation risk and fiscal concerns stemming from expansionary fiscal operations and monetary easing. As long as this structure remains unchanged, we believe the effect of the rate check has a strong “time-buying” aspect.

The US Treasury readout of the US-Japan finance ministers' meeting released on 14 January includes Mr. Bessent’s statement that "the inherent undesirability of excess exchange rate volatility" and his emphasis on "the need for sound formulation and communication of monetary policy.” Markets have already priced in an early rate hike, and with Japan and the US having even carried out a coordinated rate check, the political hurdle to delaying rate hikes—thereby enlarging yen-depreciation risk—appears to have risen.

Based on the aforementioned factors, we have moved up our forecast for the next rate hike to Apr–Jun 2026 (brought forward from our previous assumption of Jul–Sep 2026). Thereafter, given that interest rates will have entered the estimated neutral rate range (roughly 1.0%–2.5%), we assume the BOJ will hike at a semiannual pace to confirm the effects of prior hikes. However, if inflation overshoots due to progress in price pass-through accompanying fiscal expansion or further yen depreciation, a faster pace of hikes may be needed. Also, against the backdrop of long-term upside inflation pressures stemming from fiscal expansion and yen weakness, we have raised our terminal rate projection from 1.25% to 1.5%.

BOJ’s turning point and challenges upon achieving the price stability target

Since the COVID-19 pandemic, while major central banks like the Fed and ECB have made policy changes at each meeting, the BOJ’s policy changes have remained gradual, roughly at a semiannual pace. Behind this is Japan’s long experience with deflation and the perception that inflation is not yet firmly anchored at 2%. In other words, we believe the BOJ has pursued a policy of tolerating a certain degree of price overshooting in order to raise underlying inflation.

However, under the current situation where there are concerns about a policy mix (the interaction of fiscal and monetary policy) in which the BOJ does not respond proactively to concerns over fiscal-driven inflation, continuing the aforementioned communication could fuel concerns about fiscal inflation.

Particularly as discussions about a consumption tax cut gain momentum ahead of the snap general election of the House of Representatives, fiscal expansion through a FY26 supplementary budget cannot be ruled out. In addition, as Prime Minister Sanae Takaichi stated at a press conference on 19 January, "The budget request for FY26 had been completed before I took office," the Takaichi administration's fiscal spending could ramp up in earnest from autumn 2026 through 2027. In such an environment, concerns over fiscal-driven inflation and the yen depreciation trend are likely to persist.

That said, at the January MPM, board member Hajime Takata proposed a rate hike, stating that the price stability target had been more or less achieved. Additionally, the Summary of Opinions from the December meeting indicated the view that if the wage growth rate in the 2026 spring wage negotiations remains at a high level, "it can be judged that the underlying trend in prices has reached 2%." From the perspective of standard monetary policy operations, once the price stability target is achieved, policy management would be required to control medium-term price stability more strictly.

As concerns about fiscal inflation grow, what is needed from the BOJ is a hawkish signal. In particular, "communication regarding the achievement of the price stability target" in the not-too-distant future could become a turning point for a hawkish signal. In that sense, Governor Ueda's statement at the January regular press conference that "as underlying inflation approaches 2%, we must pay attention to even small [upside] movements" is a significant first step.

Furthermore, should underlying inflation reach 2% in the future, two possible communication approaches are conceivable. The first is to not immediately declare the achievement of the price stability target but to cautiously assess the degree to which it has taken hold. The second is to declare the achievement of the price stability target and take a simple approach focused on the headline rate. If the BOJ emphasizes "confirming how firmly it has taken hold" while inflation concerns remain, its cautious stance could fuel market concerns.

If the BOJ continues its dovish communication and the policy mix of fiscal and monetary policy is maintained, causing long-term upward price pressure to persist, we cannot rule out the possibility that the BOJ will be forced to raise interest rates to a level exceeding the natural neutral interest rate to curb inflation, reaching a restrictive terminal interest rate. Having entered an era of inflation, it is a critical phase where conducting rate hikes in a forward-looking manner, in line with price risks, is important to minimize the shock to the economy from these hikes.

◆ **Summary of Opinions at MPM on 29-30 Oct 2025**

- It is likely that conditions for taking a further step toward the normalization of the policy interest rate have almost been met. However, the Bank needs to examine to what extent the underlying inflation rate has become entrenched.
- With a shrinking equilibrium mindset remaining in place, it was necessary for the Bank to discuss headline inflation separately from underlying inflation. However, with the changing norm in Japan, straightforward communication that emphasizes developments in headline inflation is now desirable.

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