Daiwa Securities

Daiwa’s Economic View

Key points for March BOJ meeting: Middle East risks and maintenance of rate hike expectations

- BOJ is likely to decide to maintain current monetary policy at March meeting
- The focus will be on how well BOJ can maintain expectations for rate hikes considering situation in the Middle East
- When it comes to upside and downside risks to underlying inflation posed by the Middle East situation, we think BOJ should place more emphasis on upside risks

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Positioning of March meeting and basic stance on policy decisions

The “Summary of Opinions” from the previous January meeting suggested that the distance to the next rate hike was narrowing. This was indicated by concerns about the risk of falling behind the curve, as well as arguments that the BOJ should not spend an excessive amount of time verifying the impact of rate hikes.

However, following the subsequent outbreak of the Iran war, uncertainty surrounding the geopolitical landscape has recently increased. At the House of Representatives' Financial Affairs Committee on 4 March, BOJ Governor Kazuo Ueda mentioned the possibility that the escalating tensions in the Middle East could exert downward pressure on the economy and the underlying inflation rate. On the other hand, he also stated that over the medium to long term, it could push up underlying inflation by raising inflation expectations.

With the emergence of a new supply shock in the form of the Iran war, the BOJ now needs to assess the nature and magnitude of its impact on the economy and prices. Therefore, the BOJ will likely maintain its current monetary policy at the March meeting. However, it is highly likely that new language will be added to the statement regarding “the impact of the Middle East situation on Japan's economy and prices through channels such as resource prices.”

Furthermore, it is anticipated that board member Hajime Takata will again propose a rate hike at the March meeting, arguing that the “price stability target has been generally achieved," as he did at the previous meeting. Meanwhile, in a speech on 13 February, board member Naoki Tamura stated his view that the price stability target could be judged as achieved once wage increases consistent with the 2% target are confirmed. However, the release of the first tally of responses for the 2026 spring wage negotiations is scheduled for 23 March, meaning that additional information on wage trends will still be limited at the time of the March meeting. For this reason, the likelihood of board member Tamura proposing a rate hike at this meeting is considered low.

Under the circumstances, the more significant point of focus for the March meeting will be how the BOJ communicates its stance on the timing and pace of future rate hikes in light of the Iran war, and to what extent it can sustain market expectations for such hikes. However, if there is no progress toward de-escalating the Iran war by the time of the meeting, it will likely be difficult for the BOJ to specify the timing of a rate hike at a stage where it cannot fully assess the macroeconomic impact.

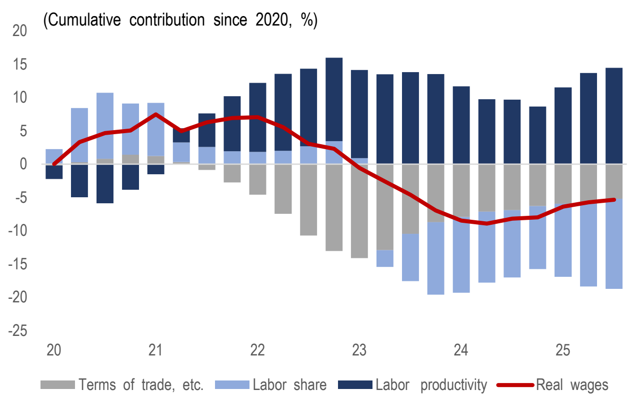
That said, by the time of the April meeting, substantial new information will be available, including (1) the first tally of responses from the 2026 spring wage negotiations (23 Mar), (2) the BOJ Tankan survey (1 Apr), and (3) corporate hearings from the BOJ branch managers' meeting (6 Apr). At the April meeting, the BOJ is expected to re-examine its economic and price outlook, including the Middle East situation, based on this data, and make a judgment on the timing of a rate hike.

Downside risks to underlying inflation

An exogenous supply shock, such as a rise in crude oil prices, can reduce real purchasing power by worsening the terms of trade, potentially leading to downward pressure on underlying inflation through deterioration of the output gap.

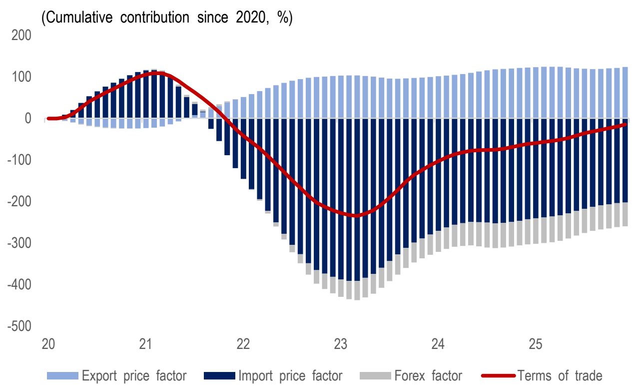
Indeed, the decline in real wages since 2022 had been partly caused by the worsening of the terms of trade—an outflow of income overseas—due to the surge in crude oil prices and yen depreciation triggered by Russia's invasion of Ukraine. In the current tense situation in the Middle East, if crude oil prices were to remain high or rise further, a vicious cycle could occur in which the yen would depreciate due to concerns about a worsening trade balance, pushing import prices even higher.

Decomposition of Contribution to Real Wages (cumulative contribution)



Source: Cabinet Office, BOJ, Ministry of Internal Affairs and Communications (MIC), Ministry of Health, Labour and Welfare (MHLW); compiled by Daiwa.

Decomposition of Contribution to Terms of Trade (cumulative contribution)

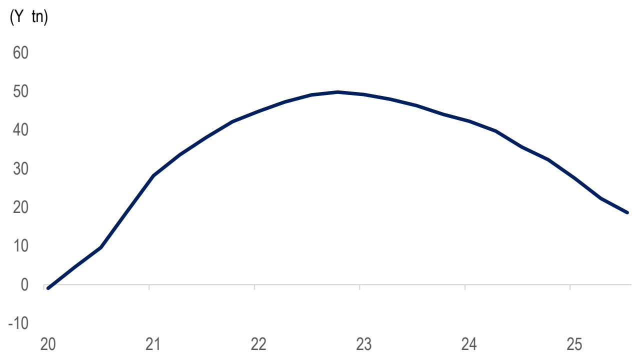


Source: Cabinet Office, BOJ, MIC, MHLW; compiled by Daiwa.

Specifically, in a scenario in which WTI crude oil prices hovered around $90, we forecast a high probability that real wage growth would turn negative again in the second half of 2026. However, periods of negative real wage growth have been repeatedly observed in the past. The more important point would be how much consumption capacity households still retain to withstand shocks in light of their asset levels and composition.

In this regard, nominal excess savings held by the household sector are currently acting as a short-term buffer. Therefore, it is unlikely that a supply shock originating from high oil prices will immediately lead to a significant macroeconomic decline in consumption or a sharp drop in underlying inflation. (For details, please refer to *Daiwa's Economic View: Key points surrounding underlying inflation: High oil prices and household resilience*.)

Household Excess Savings



Source: BOJ; compiled by Daiwa.
Note: Excess savings are calculated by subtracting the estimated value from the trend line of household cash and deposits (from 2015 to end-2019) from the actual stock of cash and deposits (4-quarter backward moving average).

However, if persistently high oil prices are accompanied by a bigger stock market correction than we have seen so far, the risk of the impact on household consumption behavior becoming more pronounced than anticipated cannot be ruled out. To begin with, we should confirm any early signs of change in household and corporate sentiment or corporate earnings plans in response to escalating Middle East tensions, while closely monitoring the outcome of the Middle East situation and market fluctuations.

Upside risks to underlying inflation

A rise in crude oil prices is essentially a relative price change in a specific good (energy) and does not, in itself, permanently push up underlying inflation. The crucial factor is whether this supply shock spills over into the mechanisms for determining general prices, such as inflation expectations, wages, and price pass-through behavior.

As a rule, monetary policy does not react to temporary supply shocks. However, if such a shock affects the components of underlying inflation, the BOJ will need to consider responding to it as a clear upside risk. In fact, as of the January meeting, the BOJ had already indicated a cautious stance regarding the impact of forex rate fluctuations on underlying inflation. As such, the central bank appears to have increased its awareness of the risk of falling behind the curve due to price overshoots.

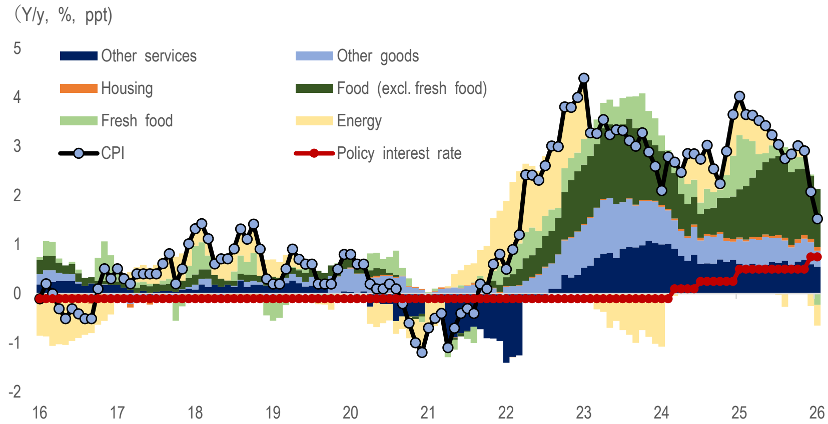
In evaluating the current supply shock, it is important to note that the current environment—in which labor shortages have become structural and the 2% price stability target is within realistic reach—is different from what it was in 2022. The price increases since 2022, partly driven by high oil prices and yen depreciation amid widening Japan/US interest rate differentials, had the effect of helping to change the deflationary mindset that had long been entrenched in the Japanese economy.

Now, however, we are at a stage where the 2% price stability target is already in sight. If the BOJ were to prolong its cautious stance for the same reason as before (a supply shock) and maintain a clearly accommodative policy interest rate, the risk of its policy response falling behind the curve could increase in the medium to long term. Consequently, scenarios in which the BOJ would be forced to make abrupt policy adjustments in the future cannot be ruled out.

There will not always be ample time available to assess the impact on underlying inflation, particularly in situations in which high crude oil prices and yen depreciation are tending to occur at the same time. While the household sector is showing a certain degree of resilience, downside risks through supply/demand adjustments are unlikely to materialize in the short term. However, if the policy response is delayed, upside risks through inflation expectations and price pass-through behavior could become entrenched over the medium to long term. While it will depend on future market fluctuations stemming from the Middle East situation, we think we are currently in a time in which upside risks to underlying inflation should be weighed more heavily than downside risks.

Furthermore, continuing with gradual rate hikes could mitigate upside inflation risks as well as help ease the risk of worsening terms of trade by curbing excessive yen depreciation. In light of these points, the BOJ will very likely maintain its stance towards monetary policy normalization, while continuing to carefully assess the impact of the Iran war on the economy and prices.

Headline CPI, Policy Interest Rate



Source: MIC, BOJ; compiled by Daiwa.

Political factors and constraints regarding forex rates

Escalating tensions in the Middle East could further complicate communication with the government regarding the next rate hike. Indeed, it was reported that Prime Minister Sanae Takaichi expressed a cautious stance regarding additional rate hikes at the meeting she had with Governor Ueda on 16 February. Furthermore, on 25 February, candidates widely seen as relatively dovish were proposed to the Diet as successors for BOJ policy board members, indicating that the government's stance on monetary policy continues to be a significant constraint on the BOJ's policy operations.

On the other hand, the readout of the US/Japan finance ministers' meeting released in January stated that US Treasury Secretary Scott Bessent noted "the inherent undesirability of excess exchange rate volatility," and emphasized "the need for sound formulation and communication of monetary policy." Based on these remarks, if the US side perceives that the BOJ's cautious stance is increasing the risk of excessive yen depreciation, it could send a message encouraging a move towards monetary policy normalization.

Of course, with recent yen depreciation being due to a combination of multiple factors, including the geopolitical factor constituted by the Iran war, it cannot be explained by monetary policy alone. Nevertheless, when considering the BOJ's rate hike path, the stances of both the Japanese and US governments and the nature of their inter-governmental communication have become factors that cannot be ignored. Notably, PM Takaichi is scheduled to meet with President Donald Trump at the White House on 19 March (US time). We will take careful note of what is discussed at this meeting and the government's subsequent stance.

Message at the press conference: A plausible scenario

Based on the above, the following three factors will likely play a key role in the next rate hike decision: (1) an assessment of the impact of crude oil prices and the Iran war, (2) the extent of yen depreciation, and (3) communication between the government and the BOJ, as well as between Japan and the US.

Considering the depreciation of the yen, we believe there will be a particularly limited amount of time available to assess the impact of (1) above. Under these circumstances, the BOJ will likely first confirm whether there are any initial signs of change in corporate and consumer sentiment or corporate profit plans, using data from sources like the BOJ Tankan survey and hearings from the branch managers' meeting.

At the press conference after the March meeting, Governor Ueda will likely express the view that uncertainty is increasing due to the rise in resource prices triggered by the Iran war, while also mentioning that there could be both upward and downward pressure on underlying inflation. On that basis, he is likely to send a message that leaves room for policy adjustments at the April meeting, while securing a free hand for the time being, by positioning the information from the Tankan survey and hearings from the branch managers' meeting as key clues for gaining an initial understanding of the situation.

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