

# Daiwa's View

FICC Research Dept.

## Central bank decisions amid supply shocks: Where does BOJ's reaction function lie?

- BOJ policy decision difficulties highlighted by responses from major central banks
- BOJ's monetary policy stance is caution, but not a retreat
- April meeting to test BOJ's additional rate hiking strategy

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As tensions in Iran escalate, shocks stemming from energy prices are once again beginning to weigh heavily on the global economy, as well as on the policy decisions of central banks around the world. While upward pressure is being exerted on prices, downward pressure on the economy is likely to emerge due to declining real incomes and heightened uncertainty. [The defining characteristic of supply constraint shocks](#) is that they simultaneously exert opposing forces on both inflation and growth. It is difficult to predict in advance how long these effects will last or how they will spread. As such, monetary policy will face a situation in which either taking action or doing nothing will each entail risks.

### BOJ policy decision difficulties highlighted by responses from major central banks

Even though they are facing the same supply shock, the policy stances adopted by central banks around the world are not uniform. In response to this shock, central banks have generally adopted a more hawkish stance, but the priority (weight) of their decisions (regarding degree to which they should be wary of persistent inflation and how much of a downturn in growth they are willing to tolerate) varies from country to country.

The BOE has taken the most proactive stance amid the current situation. Their statement emphasizes the need to be vigilant against secondary spillover effects stemming from wage and price-setting behavior, highlighting a stance that prioritizes inflation control over growth considerations. Even in the case of a supply shock, there are clear indications that the authorities are highly vigilant about the possibility of inflation expectations becoming unstable. As such, they are prepared to take preemptive action via monetary policy.

Meanwhile, compared to the BOE, the ECB took a slightly different approach. European Central Bank President Christine Lagarde described the situation as "well positioned," acknowledging the severity of the shock while stressing that the focus of policy decisions remains squarely on the sustainability of inflation over the medium term. The approach is to assess not the crude oil prices themselves, but rather the extent to which indirect and secondary effects take hold. A key feature of this approach is that it does not automatically predetermine policy responses. Rather than saying that the ECB has shifted toward a hawkish stance, it would be more accurate to describe their position as one of being willing to "wait" under certain conditions.

While maintaining a patient stance, the Fed has felt somewhat uneasy. Even though its policy interest rate was left unchanged, inflation and growth forecasts were revised upward. The atmosphere surrounding monetary policy has become even more tense. While the Fed has not signaled an intention to immediately counteract supply shocks through monetary policy, its sensitivity to inflation risks has certainly increased.

The Riksbank can be described as a central bank that has outlined its reaction function in relatively explicit terms. The Bank has indicated that it will raise interest rates even if economic activity and employment weaken, provided that inflationary pressures persist, but will shift to easing only if demand deteriorates significantly. Here, it directly outlines the trade-offs under supply shocks in policy terms.

## BOJ's monetary policy stance is caution, but not a retreat

Taking into account these international central bank responses, the BOJ is also entering a phase in which the very basis of its decision-making under supply shocks is being called into question.

Even though the policy interest rate was left unchanged [at the March Monetary Policy Meeting \(MPM\)](#), board member Hajime Takata voted in favor of hiking rates, as he did at the previous meeting. A noteworthy point is that Takata's rationale for advocating interest rate hikes has shifted from "recovery for the global economy" to "risk of secondary spillover effects for price increases originating from overseas to domestic prices through the wage- and price-setting behavior of firms." This suggests concerns that, even in a situation where the economy is being dragged down to some extent by escalating tensions in the Middle East, price-side risks should be given greater emphasis.

In its Statement on Monetary Policy, the BOJ went a step further than simply presenting economic/price outlooks and its recognition of risks. Indeed, it also took the initiative to outline the approach for its future conduct of monetary policy. Given that, in recent years, the Bank has generally refrained from commenting on its monetary policy stance at meetings where it has kept the policy interest rate unchanged, this latest statement is somewhat of an exception. Amid growing uncertainty due to the escalating tensions in the Middle East, we can probably interpret that the BOJ intended to reaffirm its basic recognition of current economic and price conditions while also conveying to the market that its overall direction toward normalizing monetary policy remains unchanged.

### ◆ Statement on Monetary Policy at March BOJ MPM (19 Mar 2026)

As for the conduct of monetary policy, given that real interest rates are at significantly low levels, **if the outlook for economic activity and prices presented in the January Outlook Report will be realized, the Bank, in accordance with improvement in economic activity and prices, will continue to raise the policy interest rate and adjust the degree of monetary accommodation.**

The new statement "**Attention should also be paid to the impact of the rise in crude oil prices on the outlook for underlying CPI inflation**" is also important. Even though the BOJ has yet to determine whether rising crude oil prices will push up underlying inflation, the fact that it has begun to explicitly acknowledge that possibility can be interpreted as a message that goes one step further than before.

During his post-meeting press conference, BOJ Governor Kazuo Ueda commented on the impact of the escalating tensions in the Middle East on underlying inflation, stating, "There appeared to be slightly more policy board members who placed importance on upside price risk than on downside price risks." Amid concerns about risks in both directions, comments from policy board members regarding the assessment of price risks suggest that, viewed on a net basis, the outlook is shifting slightly toward higher-than-expected inflation.

For Japan, we cannot rule out the risk that rising crude oil prices and yen depreciation occurring at the same time could further intensify inflationary pressures and trigger an economic slowdown, potentially leading to stagflation. Under such circumstances, the difficulty of conducting monetary policy is certainly increasing.

However, even under these circumstances, the BOJ continues to consciously maintain interest rate hikes as an important policy option, taking into account the risks of higher-than-expected inflation and yen depreciation. With central banks around the world adopting relatively more hawkish stances, if the market foresees a BOJ's decision to postpone rate hikes, awareness of diverging monetary policies could emerge, posing a risk of further yen weakness. A weaker yen would push up import prices, which could once again impact price outlooks and inflation expectations and, as a result, the BOJ's own freedom (flexibility) in terms of conducting monetary policy could be reduced. [In times of crisis during a period of yen weakness](#), the exchange rate is less able to act as a shock absorber. Depending on the circumstances, there is a risk of a "triple dip" (= falling stock prices, falling bond prices, and yen depreciation occurring at the same time). Such concerns are already widely recognized.

At his press conference, Ueda stated that even if rising crude oil prices were to dampen economic growth, interest rate hikes would still be possible if such a situation were deemed temporary and unlikely to have a significant impact on the underlying inflation rate. In other words, the BOJ's decision-making criteria are based not on short-term fluctuations in growth rates, but strictly on the sustainability (improvement) of underlying price trends.

In this regard, the BOJ's reaction function shares similarities with that of the Riksbank in that it does not rule out rate hikes even in the face of supply shocks, depending on the conditions. Meanwhile, rather than explicitly clarifying conditions to strongly drive the market forward, such communication this time has placed greater emphasis on outlining decision-making criteria and readiness. In that sense, the BOJ's approach is similar to that adopted by the ECB. Our understanding is that, while the BOJ's policy philosophy incorporates elements of the Riksbank's approach, the policy stance leans toward that of the ECB and is compounded by the exchange rate constraints unique to Japan.

### **Implications for BOJ's monetary policy: Apr meeting to test BOJ's additional rate hiking strategy**

[This supply shock does not necessarily force the BOJ to choose between a "wait-and-see stance" or "immediate action."](#) The responses from major overseas central banks point to a shared orientation. Specifically, rather than focusing on the supply shock itself, they are making conditional decisions after assessing how it will affect wage- and price-setting behavior as well as inflation expectations.

Amid such a supply constraint shock, monetary policy is always forced to make decisions based on incomplete information. If central banks act too quickly, they run the risk of overreacting. If they don't act, they risk falling behind. The key is not to automatically choose one or the other, but to maintain a clear focus on what to look for and at what stage to make a decision.

However, an important point for the BOJ is that the April meeting should be more than just a stepping stone. Based on the current data, the April meeting seems evenly split in terms of whether the Bank will or will not hike rates. Indeed, a decision could remain hanging in the balance right up until the April meeting. Whether or not the BOJ proceeds with a rate hike will test market confidence in the BOJ's strategy to continue hiking interest rates. In fact, during Ueda's press conference, while expressing caution regarding the potential negative impact of a US/Israeli-led attack on Iran, he framed a message in which the BOJ will "stubbornly defend" its policy of hiking interest rates.

That is precisely why, if the BOJ fails to hike rates in April even as the conditions are falling into place, there is a risk that this decision will be perceived not as "prudence" but as a "postponement" influenced by political considerations. In that sense, the April meeting is not likely to be a mere stepping stone. Regardless of whether or not it actually hikes rates at its April meeting, can the BOJ successfully implement its strategy of continuing to hike interest rates? In other words, the question now is whether the Bank can demonstrate to the market that it is capable of making conditional decisions and taking action when necessary.

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