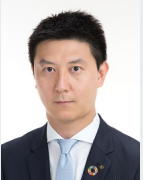


Daiwa's View

FICC Research Dept.

Risk of accelerated rate hikes and an inflection point in the forex market

- Inflation expectations and priced-in terminal rate approaching 2%
- Impact of forex rates on prices: Y161.7/\$ is estimated inflection point
- If yen depreciation continues, market may price in an accelerated pace of rate hikes



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Inflation expectations (BEI) and priced-in terminal rate approaching 2%

In the bond market, 2% holds special significance. The BOJ has set its “price stability target” at a 2% y/y increase in the CPI. Many other central banks in major advanced economies also aim for an inflation target of around 2%. The rationale for the 2% target is said to include: (1) upward bias in the CPI, (2) securing room for interest rate cuts on a real interest rate basis, and (3) global standards¹. However, these are not decisive reasons why it must be 2% and not, for instance, 1% or 3%. Ultimately, it can be said that within the region of rational inattention, the 2% has become conventionally established among central banks worldwide as a moderate level in a slightly positive territory that is not 0%.

In the JGB market, key indicators are approaching 2%. The 10-year BEI (market-based inflation expectations) reached 2% in early February, then declined temporarily, but is now approaching 2% again in response to the situation in the Middle East. Additionally, the 2-year forward 1-year OIS rate, which is a point of reference for the terminal rate in the market, has risen to 1.92%. The terminal rate is on a nominal basis, but assuming that the (real) natural rate of interest is between 0% and slightly negative, a rate hike beyond 2% would mean entering restrictive territory beyond the neutral level.

Chart 1: 10yr BEI



Source: Bloomberg; compiled by Daiwa.

Chart 2: 2yr-forward 1yr OIS Rate



Source: Bloomberg; compiled by Daiwa.

¹ BOJ Governor Haruhiko Kuroda (20 Mar 2014). [Aiming at 2 Percent Inflation. Why?—Speech at the Japan Chamber of Commerce and Industry.](#)

Impact of forex market on prices

There appears to be a certain hurdle to be overcome for markets to price in rate hikes beyond 2%. That makes developments in the forex market particularly noteworthy. At the press conference following the March Monetary Policy Meeting (MPM), BOJ Governor Kazuo Ueda expressed concern that exchange rate movements are now having a greater impact on domestic prices and underlying inflation than in the past.

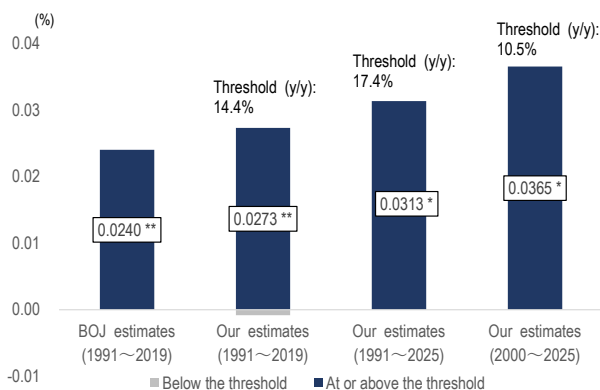
◆ BOJ Governor Kazuo Ueda: Post-MPM Press Conference (19 Mar 2026)

We would like to closely monitor the impact of exchange rate fluctuations on the economy and prices, especially, as you mentioned, on prices and eventually underlying inflation. Furthermore, we should keep in mind that the impact of exchange rate fluctuations on domestic prices has become stronger than in the past, and as a result, the possibility that they may affect underlying inflation has also increased.

In this regard, Sasaki, Yamamoto, and Nakajima (2023)² conducted an empirical analysis to determine whether the pass-through to the CPI changes non-linearly when corporate cost increases—such as from producer prices, exchange rates, and wages—exceed a certain threshold. In their estimation for core CPI (excl. fresh food), they state that as long as the y/y change in the exchange rate is within about 15%, the price-boosting effect of a weaker yen is limited. However, once that threshold is crossed, a 1% depreciation of the yen is estimated to push up the CPI by 0.024ppt. While the data period for that paper is from 1991 to 2019, a report by our Senior Economist Kento Minami et al. in 22 January 2026 *Daiwa's Economic View*³ extended the data to 2025 and conducted a similar estimation. The results show that for the period from 2000 to 2025, this threshold has fallen to 10.5%, and the sensitivity to a 1% yen depreciation has also increased to 0.0365ppt.

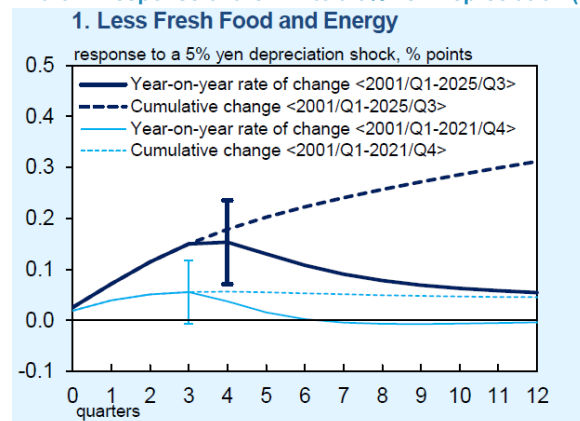
In Box 3, "Pass-Through of Import Price Increases to Domestic Prices," in the January 2026 *Outlook for Economic Activity and Prices report (Outlook Report)*, the impact of the USD/JPY rate on consumer prices is estimated using a simple VAR model. Specifically, it shows that a 5% yen depreciation shock has the effect of pushing up the CPI over three to four quarters. Furthermore, a comparison between data up to 2021 and data that includes the yen depreciation and inflation phase from 2022 onwards points out that in the latter case, the upward pressure from yen depreciation is larger and more persistent.

Chart 3: Impact of 1% Fluctuation in Forex Rate on Core CPI



Source: Reprinted from Minami and Yamamoto report.

Chart 4: Response of the CPI to a 5% Yen Depreciation (VAR)



Source: Reprinted from BOJ Outlook Report.

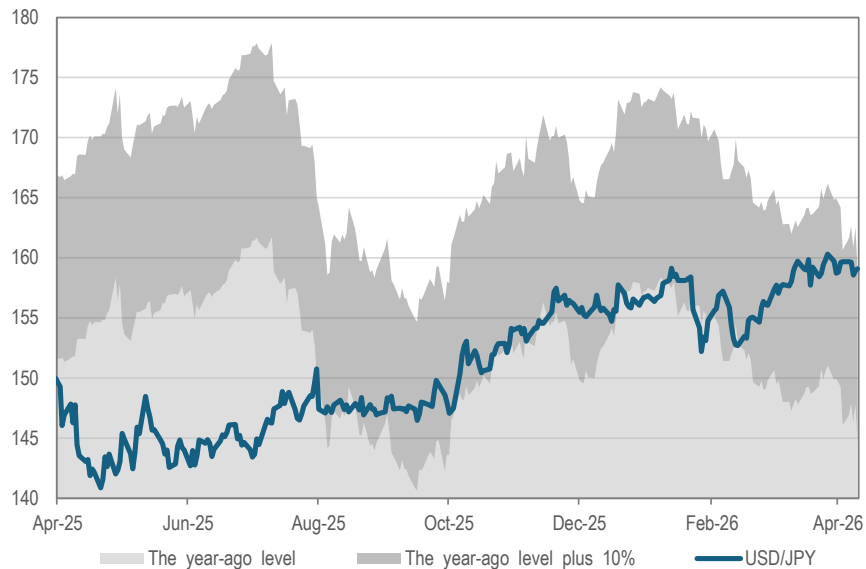
The analysis in the BOJ Working Paper examines the threshold for the annual rate of change in the exchange rate that can affect consumer prices. In the latest analysis by Minami et al., this level is estimated at around 10%. On the other hand, the analysis in the *Outlook Report* intentionally selects a 5% yen depreciation as a figure representing the magnitude of a short-term

² Takatoshi Sasaki, Hiroki Yamamoto, and Jouchi Nakajima (2023). [Nonlinear Input Cost Pass-through to Consumer Prices: A Threshold Approach](#). Bank of Japan Working Paper Series.

³ Kento Minami and Kenji Yamamoto (22 Jan 2026). [Daiwa's Economic View: Critical thresholds for yen weakness: Weak yen/price mechanism](#).

shock. Applying this to the current forex market, the USD/JPY rate one year ago was around Y147, and a 10% yen depreciation corresponds to Y161.7 ($=Y147 \times 1.1$). Also, if we consider the recent deterioration of the situation in the Middle East as a temporary shock, the USD/JPY rate just before the attack on Iran was around Y156, meaning that a 5% yen depreciation corresponds to Y163.8 ($=Y156 \times 1.05$).

Chart 5: Comparison of USD/JPY Rate with Year-ago Level



Source: Bloomberg; compiled by Daiwa.

If yen weakens beyond Y161.7, markets may price in double-pace rate hikes

Since the start of the Iran conflict, the yen has been on a gradual depreciation trend in the forex market. Although it surpassed the threshold of Y160 on 27 March, it was pushed back following the ceasefire agreement between the US and Iran, and as of the morning of the 10th, it is trading around Y159. However, the levels of Y161.7 and Y163.8, which are considered in this report as points of reference for the yen's depreciation to affect prices, are not far from the current value (+1.7ppt and +3.0ppt, respectively), considering the volatility of the forex market. Furthermore, Y161.7 is the recent peak for the USD/JPY rate (Jul 2024), a level that many market participants are watching. In a case where the yen continues to depreciate in the forex market and surpasses this level, the market's pricing of the policy rate path may change significantly based on the recognition that the pass-through to prices will increase. Looking at the current rate hike pricing in the OIS market, a hike is priced at a pace of roughly twice a year—specifically, at just under 60% probability for the April MPM, one hike fully priced in for July, and a second hike for December 2026. However, there is a risk that the market will begin to anticipate accelerated rate hikes triggered by yen depreciation. In such a scenario, the 2.5% level for the long-term yield may also become a mere waypoint, which also warrants caution.

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