Daiwa's Economic View

FICC Research Dept.

BOJ's April policy meeting and macro perspective on bond market – Changing inflation risk perceptions, decision-making constraints

- Inflation risks emerging sooner than expected, but must wait bit longer for decision
- Rate hike without "improvement" and remaining time horizon
- Logic behind shift toward hawkishness, no actions taken at Apr meeting

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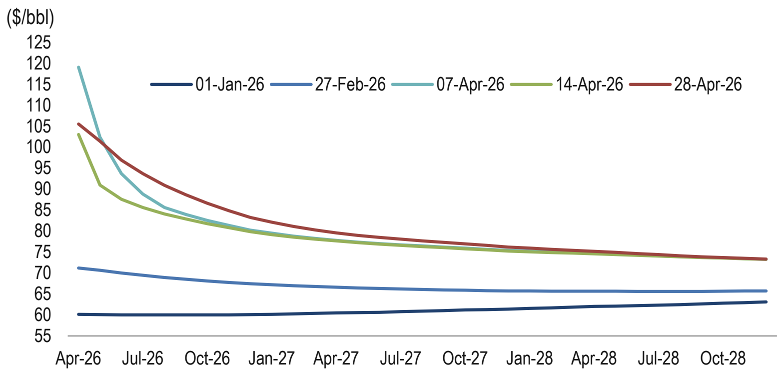
Asymmetry of downward economic growth revisions, significant upward inflation revisions

The outlook for the real economy was revised downward in the *Outlook for Economic Activity and Prices* (*Outlook Report)* released at the April Monetary Policy Meeting, while at the same time, inflation forecasts were revised significantly upward. In particular, attention was given to inflation. The outlook for core CPI is projected to be +2.8% y/y for FY26 and +2.3% for FY27, representing upward revisions of 0.9ppt and 0.3ppt, respectively, from the previous forecast. If conditions unfold as projected, core CPI is expected to exceed 2% for six consecutive years starting from FY22. Needless to say, the BOJ's "price stability target" is set at a 2% y/y increase in the consumer price index (headline).

Furthermore, even the BOJ's core-core CPI, which excludes the impact of energy prices, is projected to land at a fairly robust level in the mid-2% range during FY26-27. We can note that this content is based on the assumption that the impact of high crude oil prices will gradually spread to the prices of a wide range of goods and services over time.

A key point is that these price forecasts are based on the assumption that crude oil prices will decline over the medium to long term. The *Outlook Report* assumes that the price of Dubai crude oil will start at around $105/bbl and decline to the $70/bbl range by the end of the forecast period. If the situation in the Middle East does not stabilize (Strait of Hormuz blockade continues for extended period) and crude oil prices remain high, there would be a strong chance that inflation outlooks could be higher-than-expected.

Dubai Crude Oil Prices (futures curve)



Source: Bloomberg; compiled by Daiwa.

Actually, when looking at the Policy Board members' risk assessments regarding price outlooks, seven members indicated "higher-than-expected risks" for FY26-27. There is still a possibility that the inflation outlook will be raised further in the next *Outlook Report* (July).

Shifting focus for underlying inflation assessment

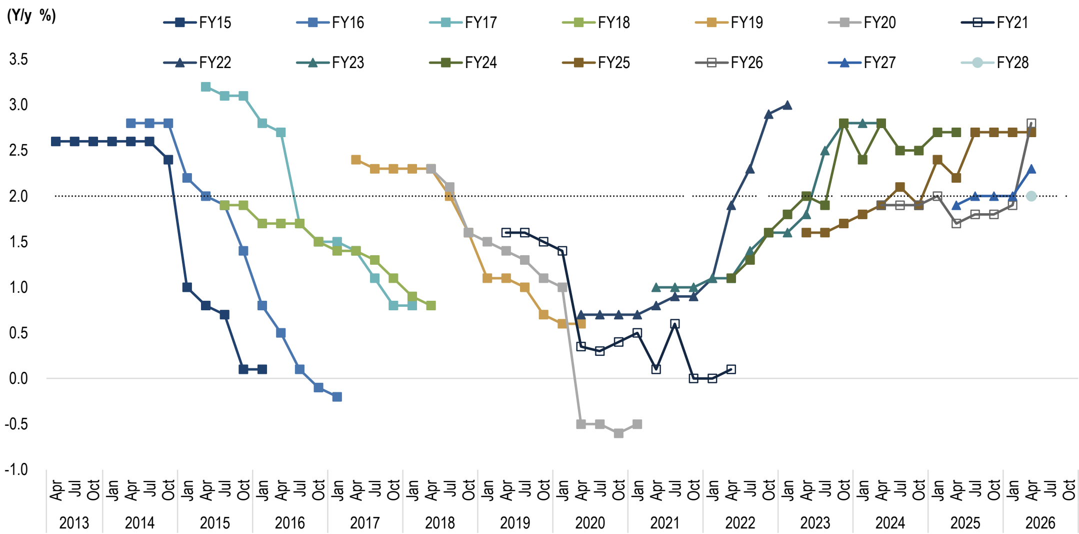
The latest *Outlook Report* and the post-meeting communications suggest that there may be a shift within the BOJ regarding its assessment of the inflation mechanisms. We were left with the impression that the Bank has moved beyond the stage where this could be simply "looking through" the rise in inflation as a temporary supply shock, while concerns about the risk of accelerating underlying inflation have emerged.

The April *Outlook Report* included detailed descriptions such as, "It is necessary to pay due attention, in particular, to keep the risk of inflation significantly deviating upward from materializing and thereby exerting an adverse impact on the economy afterward." This statement appears to reflect concerns that higher-than-expected inflation could lead to excessively tight monetary policy stances in the future, which in turn could exacerbate economic volatility.

Changes in corporate behavior are also a key factor. During the period of inflation following Russia's invasion of Ukraine, price increases were relatively easy to "look through" because wage growth was limited. However, at this juncture, wages and prices are increasingly being linked, creating environments where it is becoming easier to pass on costs to higher prices. Even senior BOJ officials are referring to this as, "The current environment makes it easy to pass on costs to price increases, which means inflation is likely to accelerate" (*Mainichi Shimbun*).

Also, there is an emerging understanding that the factors that make secondary spillover effects more likely are (1) continued accommodative monetary environment and (2) the fact that 2% inflation expectations are not firmly anchored in Japan. In terms of the risk that supply shocks could feed into core inflation, the revision to the price outlook appears to be based on the view that, "There are concerns inflation could rise more rapidly than in Europe and the US" (BOJ official, according to *Mainichi Shimbun*).

Median Forecasts for CPI (excl. fresh food) by BOJ Policy Board Members



Source: BOJ; compiled by Daiwa.

Change in policy language that hints at rate hikes without "improvement"

One of the key points of interest leading up to this policy board meeting was the revision of the wording regarding the Bank's conduct of monetary policy. The previous statement read, "The Bank, in accordance with improvement in economic activity and prices, will continue to raise the policy interest rate." However, this wording was changed in the April *Outlook Report* to, "The Bank will continue to raise the policy interest rate in response to developments in economic activity and prices as well as financial conditions."

◆ **BOJ *Outlook Report* (28 Apr 2026)**

- As for the conduct of monetary policy, given that underlying CPI inflation has been approaching 2 percent and real interest rates are at significantly low levels, the Bank will continue to raise the policy interest rate and adjust the degree of monetary accommodation, in response to developments in economic activity and prices as well as financial conditions. In this regard, it will consider the timing and pace of adjustment, while closely monitoring the impact of the future course of the situation in the Middle East on Japan's economic activity and prices and examining the likelihood of realizing the baseline scenario of the outlook for economic activity and prices and the risks to the outlook.

There are three key points to note regarding this change, but the most important is that the term "improvement" was removed. First, in previous statements, the term "improvement" had served as a de facto time horizon for interest rate hike decisions. In other words, confirming that the economy and prices were "on a path to improvement" was a prerequisite for the next rate hike.

The fact that this "improvement" was omitted this time suggests that any decision to hike interest rates will not necessarily require the passage of time or gradual improvement. This can be interpreted as a clear stance that the BOJ is not ruling out a rate hike as an option, provided that inflation risks intensify, even though growth rates are being dragged down by high crude oil prices and other factors. This means that the constraints on rate hikes have been relaxed, which is at the heart of this revised wording.

Second, the Bank used the phrase "economic activity, price, and financial conditions" (inclusion of "financial conditions"). This phrasing itself is not new. Indeed, it is quite familiar to market participants. Most recently, it was used at the March 2024 meeting, where the decision was made to end YCC and negative interest rates. Prior to that decision, it was also used at the July 2018 meeting, when YCC operations were made more flexible.

◆ **Statement on Monetary Policy at July BOJ MPM (31 Jul 2018)**

- The Bank will examine the risks considered most relevant to the conduct of monetary policy and make policy adjustments as appropriate, **taking account of developments in economic activity and prices as well as financial conditions**, with a view to maintaining the momentum toward achieving the price stability target.

◆ **Statement on Monetary Policy at March BOJ MPM (19 Mar 2024)**

- With the price stability target of 2 percent, it (BOJ) will conduct monetary policy as appropriate, guiding the short-term interest rate as a primary policy tool, **in response to developments in economic activity and prices as well as financial conditions** from the perspective of sustainable and stable achievement of the target.

For the BOJ, "financial conditions" do not simply refer to the degree of monetary easing or interest rate levels. This refers to a set of criteria that encompasses not only the overall financial environment (including forex trends), but also market functions, the side effects of monetary policy, and the stability of the financial system. The inclusion of this wording can be positioned as confirming the Bank's stance of conducting monetary policy while discretionarily assessing the overall financial environment, even during periods of interest rate hikes (hawkish orientation).

Third, the Bank also touched on the "timing and pace of the adjustments." The *Outlook Report* presented a policy approach that involves making policy decisions based on assessment of how the situation in the Middle East impacts the economy and prices, the likelihood that the baseline scenario will materialize, and assessments of risks. This statement can be interpreted as one that has already factored in the possibility that, should inflation be higher-than-expected, discussions may take place regarding accelerating the pace of monetary easing adjustments. While it is unlikely that the next rate hike will exceed 25bp, there is room to move forward the "every six months" pace that the market has been anticipating.

Lingering sense of unease between hawkish outlook, keeping rates unchanged

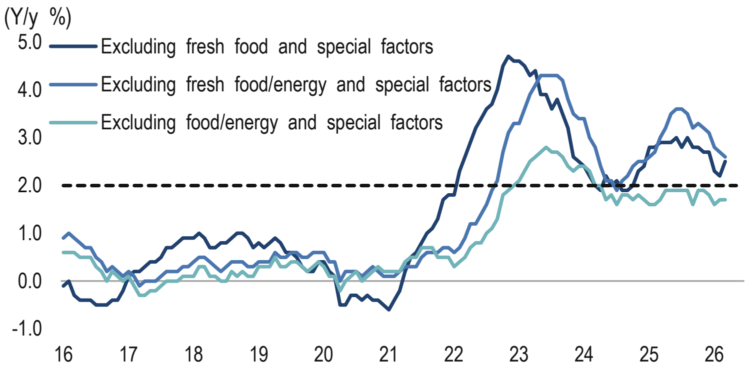
Despite these hawkish outlooks and policy statement revisions, the BOJ left its policy rate unchanged at the April meeting. Six board members agreed to keep rates the same, while three voted against that action. This marked the first time that three members voted against a decision under BOJ Governor Kazuo Ueda's leadership. This suggests that policy decisions are at a critical juncture. Ueda himself said at the press conference, "As governor, I have to take this (split vote) seriously."

Regarding the reasons for the decision to maintain the status quo, Ueda said, "The likelihood of achieving our main forecast has diminished." He also explained that "The BOJ wants to check a bit more how the Middle East conflict affects the economy and prices, and whether growth and inflation risks could change." The phrases "wants to examine a bit further" or "want to check a bit more" are frequently used by Ueda when indicating a time horizon for policy decisions. These are also characteristic expressions that he employs when postponing a decision.

In fact, according to Jiji Press, a BOJ official said, "The situation in the Middle East is unpredictable, making policy decisions difficult, but we have no choice but to make a decision based on the information and data we have gathered at that time." It appears that the significant uncertainty surrounding the situation in the Middle East was a key factor behind the decision to keep rates unchanged.

However, it is also true that questions remain as to why the Bank didn't raise interest rates in April, considering that it had signaled such a high inflation outlook and made the possibility of future rate hikes so clear. Considering that the BOJ's leadership itself may have viewed April as the most likely timing for the next rate hike, and considering that the Summary of Opinions from the March meeting was extremely hawkish, the fact that the rate was not hiked in April entails significant implications.

CPI Readings Excluding Special Factors



Source: BOJ; compiled by Daiwa.

Government casting shadow over BOJ policy decisions

In interpreting this decision, it is undeniable that developments within the government cast a shadow over the BOJ's decision-making conditions. The *Nikkei* reported that within the Takaichi administration, there were voices calling for caution based on the view that "raising interest rates would cool the economy." For a government prioritizing growth-oriented investment, the impact of monetary tightening on the economy was difficult to ignore. Here, there has been some talk about whether the BOJ can provide the grounds and data to convince the administration of the need to hike rates.

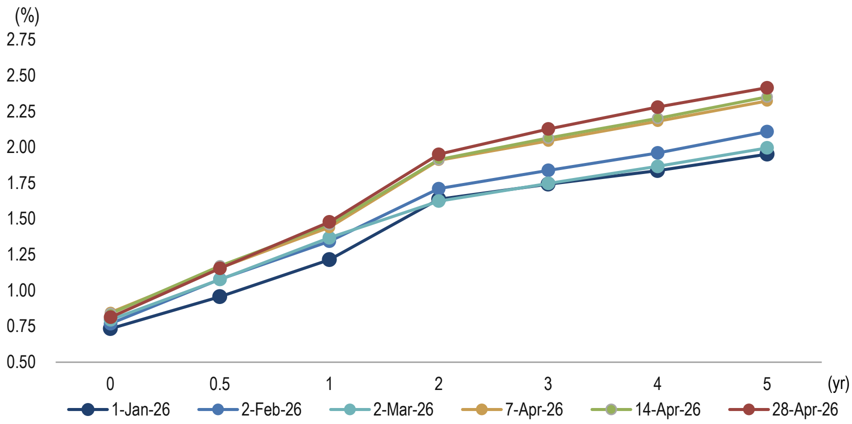
In fact, prior to this policy meeting, one senior government official said, "The situation has not stabilized. There seems to be a reluctance toward hiking interest rates within the Prime Minister's Office" (*Asahi Shimbun)*. With cabinet ministers attending the policy board meeting, it is clear that the government was closely monitoring the Bank's monetary policy decisions.

The *Nikkei* also pointed out that the BOJ miscalculated the prolonged turmoil in the Middle East. As hopes for an early resolution faded, concerns within the government about the risk of an economic slowdown increased. A senior Cabinet Office official who supports Minister of State for Economic and Fiscal Policy Minoru Kiuchi has even gone so far as to say, "If the economy collapses because of a hasty interest rate hike at this point, the BOJ will be held responsible." Within the administration, there is an emerging perception that accountability for rate hike decisions resides with the BOJ.

According to government sources, senior administration officials confirmed with Ueda in mid-April that, "Even if interest rates are raised now, the trend of a weaker yen and higher prices will remain unchanged." These government officials also signaled that the BOJ should now postpone a rate hike (Kyodo News).

Furthermore, another government official said, "I don't know if Prime Minister Takaichi will allow an interest rate hike. Depending on the situation, a rate hike even at the June meeting may be difficult" (*Asahi Shimbun*). We can conclude that the BOJ found itself in a situation where it had to weigh both the risk of "falling behind the curve" due to delays in curbing inflation and the risk of intensifying friction with the world of politics through interest rate hikes.

Market Expectations for Japanese Policy Interest Rate



Source: Bloomberg; compiled by Daiwa.

How to prepare for June meeting

The BOJ reaffirmed its commitment to continuing the normalization of interest rates and adopted a "hawkish hold" decision, which could lay the groundwork for a rate hike at its next meeting in June. While denying the view that the BOJ is "falling behind the curve," Ueda said that in order to avoid "falling behind the curve" in the future, that the Bank will make an "appropriate" (rate hiking) decision at the next meeting in order to avoid "falling behind the curve" in the future. Meanwhile, it remains unclear whether an interest rate hike can actually be implemented in June.

Also, during his post-meeting press conference, Ueda explicitly stated, "Unless there is a significant economic downturn, interest rates could be hiked if the risk of higher-than-expected inflation materializes." He went on to say that, "In some cases, an interest rate hike is possible," even if the Strait of Hormuz remains effectively closed. Such comments clearly indicate a stance that the BOJ will not necessarily rule out interest rate hikes, even amid ongoing supply constraints.

Meanwhile, an approach that incorporates "hawkish" elements into the Bank's communications and implies a potential rate hike at the next meeting would be a double-edged sword. If the period of holding off on interest rate hikes drags on, the market will see through the "talking but not acting" policy stance and the message will gradually lose its impact. The June meeting will likely be a test of the BOJ's ability to address the risk of higher-than-expected inflation while simultaneously maintaining public confidence in its conduct of monetary policy.

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