Daiwa Securities

Daiwa's View

Stagflation risk and central bank credibility

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Stagflation risk and central bank credibility

Following the rise in energy prices associated with the Iran conflict, stagflation risk is once again becoming a concern. According to Blanchard and Galí (2007)[1], whether an oil price shock transforms into stagflation depends not on its scale, but on the transmission mechanisms, such as wage structures and the credibility of monetary policy.

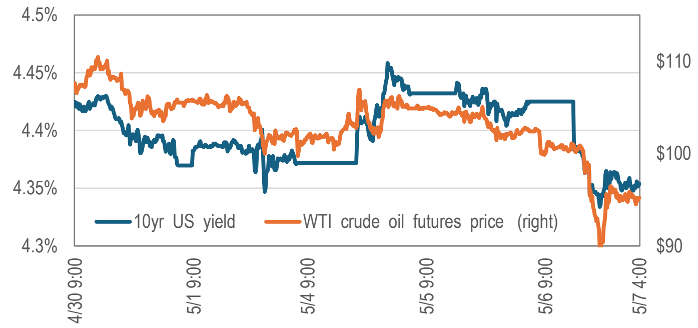
The current Japanese economy is entering a different phase than before, characterized by a tightening labor market and rising inflation expectations. Meanwhile, currency intervention only temporarily suppresses yen depreciation pressure and is not a substitute for a comprehensive policy response.

In this environment, anchoring inflation expectations is the most critical task for the BOJ. Considering both foreign exchange stability and price stability, it is highly probable that an interest rate hike will be implemented at the June Monetary Policy Meeting (MPM) to maintain policy credibility.

Overseas markets during Japan's holiday period

Reviewing US yields during the Japan's Golden Week holiday period, the situation in the Middle East remains the main theme. In the first half of the week, with reports of a missile attack by Iran on the UAE and WTI crude oil futures exceeding $100/bbl, the 10-year UST yield surpassed 4.45% at one point. However, on the 6th, following reports that the US and Iran were close to an agreement through a memorandum of understanding, crude oil prices dropped sharply, and the 10-year yield fell significantly to around 4.35%. As a result, the yield is slightly lower compared to the 4.39% seen on the evening of 1 May (Japan time).

Chart 1: 10yr UST Yield and WTI Crude Oil Futures Price During the Holiday Period



Source: Bloomberg; compiled by Daiwa.

[1] Olivier J. Blanchard and Jordi Gali (2007). "THE MACROECONOMIC EFFECTS OF OIL SHOCKS: WHY ARE THE 2000S SO DIFFERENT FROM THE 1970S?" NBER.

Impact of currency intervention on Japanese interest rates

On 30 April, the yen appreciated by about Y4, or approximately 2.4% against the dollar, from the previous day. It is estimated that currency intervention of around Y5tn was conducted[2]. The 1-day volatility of the USD/JPY pair measured over the past year is about 0.54%, and the 2.4% move corresponds to roughly a four-sigma move. It is uncertain whether actual intervention occurred during the Japan's holiday period, but the USD/JPY rate continued to show nervous, volatile price action, moving from the Y155 level to the high 157 range.

In its *Outlook for Economic Activity and Prices* report (*Outlook Report*) released after the April MPM, the BOJ used the term "financial conditions" as a precondition for further rate hikes, indicating that it has been closely monitoring the forex market based on its view that yen depreciation is having a growing impact on underlying inflation. The successful avoidance of sharp yen depreciation via currency intervention suggests a diminished near-term need for a rate hike.

However, while currency intervention may be able to substitute for a rate hike in the short term, it is structurally unsustainable. Under the Mundell-Fleming model, known for the international finance trilemma, it is not possible to simultaneously achieve a fixed exchange rate and an independent monetary policy under free capital mobility. Within a policy mix combining forex policy and monetary policy, if the authorities wish to prevent yen depreciation beyond a certain level, a narrowing of interest-rate differentials through rate hikes would become necessary. Amid changes in fundamentals, including a deterioration in the terms of trade due to higher energy prices and a more hawkish monetary policy stance among major central banks, it can be said that the government's desire to avoid yen depreciation is increasing the need for rate hikes.

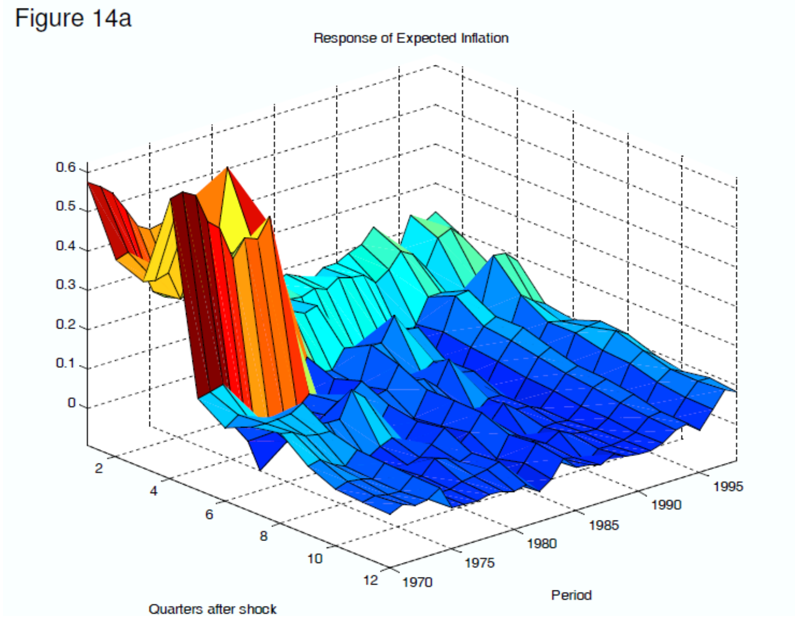
Stagflation: Three Conditions

The surge in energy prices caused by the Iran conflict has raised concerns about stagflation, in which inflation and an economic downturn proceed simultaneously. Blanchard and Galí (2007) analyzed why the oil price hikes of the 1970s led to stagflation, while those from the 1990s onward did not have the same macroeconomic consequences, using VAR analysis and a New Keynesian macro model.

Their findings indicate that the difference between the two periods was not due to the scale of the oil price shocks themselves, but to changes in the shock's transmission mechanism. Specifically, they point to three factors: (1) wage rigidity in the labor market, (2) the decline in the share of energy in GDP, and (3) the credibility of monetary policy. In particular, they emphasize the importance of monetary policy credibility, arguing that in the 1970s, confidence in central banks' commitment to containing inflation was low; therefore, the rise in oil prices led to an increase in expected inflation, lowered real interest rates through insufficient adjustment in nominal interest rates, and thereby amplified inflationary pressure in a self-reinforcing manner. By contrast, they state that, since the Volcker period in the early 1980s, the credibility of central banks' commitment to responding strictly to inflation has been established. As a result, the impact of higher oil prices on expected inflation declined significantly, and the effects on both inflation and GDP were consequently limited.

[2] Kenta Tadaide (1 May 2026). *Daiwa's View: Golden Week bazooka.*

Chart 2: Impact of Oil Shock on US Inflation Expectations (rolling impulse response)



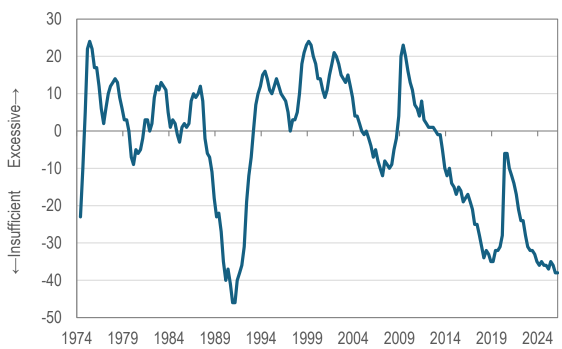
Source: Reprinted from Blanchard and Galí (2007).

Stagflation risk and Japan's economy

Let us examine the three conditions identified in the above paper in light of the current state of Japan's economy. First, we may need to become more vigilant about the labor market, the first factor. In the 1970s, workers' strong bargaining power, backed by powerful labor unions, caused the energy shock to develop into broad-based inflation. Since the late 2010s, "labor shortages" have increasingly become a common feature of the Japanese economy regardless of industry or region. The tightness of the labor market as seen in the employment conditions DI in the BOJ Tankan has already surpassed the level at the start of the statistics in 1974 and has reached a level comparable to that seen during the bubble economy era.

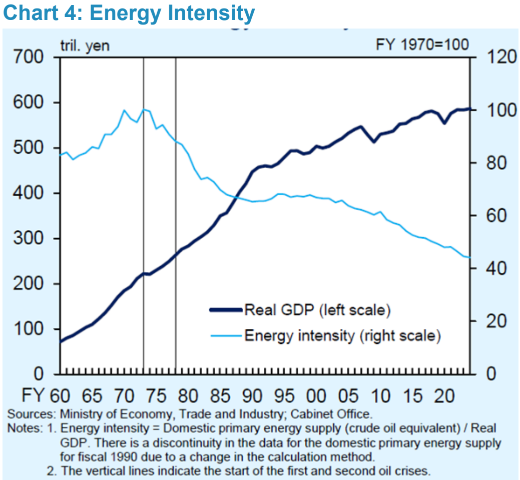
On the other hand, the situation regarding the energy share is substantially different. In Box 2 of the BOJ's April *Outlook Report*, "Impact of a Surge in Crude Oil Prices on Japan's Prices," the BOJ compares the 1970s with the present. In that analysis, using input-output tables, the BOJ shows that the impact of higher crude oil prices on output prices has declined. Its macro-level analysis also indicates that, compared with the period of the oil shocks, Japan has become less susceptible to energy shocks as the energy intensity, which indicates efficiency, has improved.

Chart 3: Employment Conditions DI in BOJ Tankan (all industries)



Source: BOJ; compiled by Daiwa.

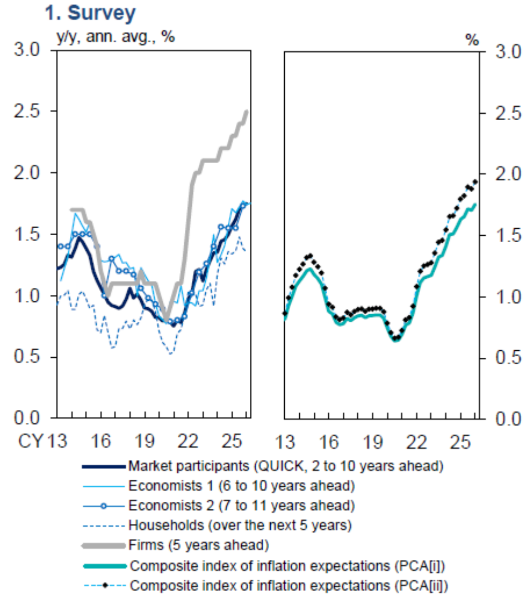
Chart 4: Energy Intensity



Source: Reprinted from BOJ Outlook Report.

Finally, with regard to central bank credibility and inflation expectations, Japan has long had a norm that prices would not rise, formed by the prolonged period of deflation after the collapse of the bubble economy. However, due to the recent tightening of the labor market, as well as the weak yen and high energy prices since the COVID-19 pandemic, the deflationary mindset has been shifting towards an inflationary mindset. Against this backdrop, various figures of inflation expectations measured by the BOJ have risen and have generally approached 2%, the same level as the price stability target. With the addition of a new shock from the Iran conflict to these three factors, the key question is whether inflation expectations can be anchored at 2%.

Chart 5: Inflation Expectations

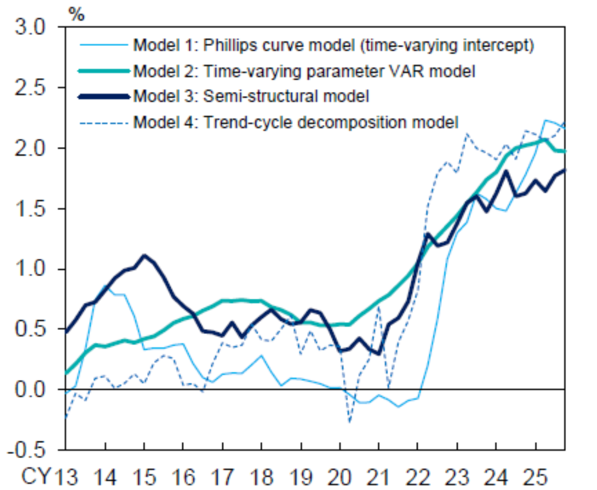


Sources: Bank of Japan; QUICK, "QUICK Monthly Market Survey <Bonds>"; JCER, "ESP Forecast"; Consensus Economics Inc., "Consensus Forecasts"; Bloomberg.

Notes: 1. "Economists 1" shows the forecasts of economists in the *Consensus Forecasts*. "Economists 2" shows the forecasts of forecasters surveyed for the *ESP Forecast*.
2. Figures for households are from the *Opinion Survey on the General Public's Views and Behavior*, estimated using the modified Carlson-Parkin method for a 5-choice question.
3. Figures for firms show the inflation outlook of enterprises for general prices (all industries and enterprises, average) in the *Tankan*.
4. The composite indexes of inflation expectations are for 10-year-ahead expectations. They are staff estimates and are obtained by extracting the common component, using principal component analysis (PCA), from the inflation expectations of households, firms, and experts. For details on PCA[i] and PCA[ii], see "The Concept and Measurement of Underlying Inflation," Bank of Japan Monetary Affairs Department, March 2026.

Source: Reprinted from BOJ Outlook Report.

Chart 6: Trend Inflation



Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications; Cabinet Office; Bank of Japan; QUICK, "QUICK Monthly Market Survey <Bonds>"; Consensus Economics Inc., "Consensus Forecasts"; Bloomberg; Google Trends.
Note: Figures are staff estimates.

Source: Reprinted from BOJ Outlook Report.

Outlook for BOJ's June rate hike

Even after the hawkish tone of the April BOJ MPM, market pricing for a June rate hike remains around the 60% level, and below 90% even for a hike by July. As such, the market has not gained strong conviction in a rate hike. In this environment, the author believes that the probability of a June rate hike is high. As Japan faces stagflation risk, the BOJ is under increasing pressure to keep inflation expectations anchored. From the perspective of both exchange rate stability and inflation containment, a rate hike is becoming not merely one policy option, but an increasingly important means of preserving policy credibility.

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