Daiwa Securities

Daiwa's View

BOJ headed for June rate hike

- Policy delays will materialize through interest rates and exchange rates, shifting the focus to effectiveness of rate hike itself

Kenji Yamamoto
81-3-5555-8784
kenji.yamamoto@daiwa.co.jp

Daiwa Securities Co. Ltd.

Governor Ueda's speech signals a de facto June rate hike by using the term "rate hike"

The closely watched speech by BOJ Governor Kazuo Ueda clarified the preconditions for the policy decision ahead of the June Monetary Policy Meeting (MPM). In the speech, he expressed the view that "it will be necessary to thoroughly discuss the pros and cons of raising the policy interest rate" if upside risks to inflation increase, using the more forceful expression "thoroughly." This was not merely a conditional statement, but rather a statement signifying a shift to the stage of substantive deliberation on a rate hike at the upcoming meeting.

In the previous two rate-hike phases, markets interpreted statements in speeches by the Governor and deputy governors that the BOJ would "consider the pros and cons of raising the policy interest rate at the next meeting" as de facto notice of a rate hike. The BOJ also understands what it means to use the term "rate hike," and the latest remarks should be regarded as a de facto signal of a June rate hike. This week's *Nikkei* report also indicated that support for a rate hike is growing within the BOJ, and that there is a view that "if the BOJ misses the June opportunity, there are concerns of falling behind the curve." This indicates that the policy decision is at a stage where the cost of postponement is being strongly considered.

Reassessment of Middle East risks: "Receding concerns over downward pressure on the economy"

With regard to the Middle East situation, which was cited as the main reason for the BOJ's decision to forgo a rate hike at the April meeting, the risks were reassessed in this speech. While rising crude oil prices can be downward pressure on the economy through a deterioration in the terms of trade, they also become a factor pushing up prices across a wide range of items as price pass-through progresses through corporate transactions.

On this point, Governor Ueda indicated that accumulated corporate profits and continued wage increases are functioning as support, and that the current situation is not one where high crude oil prices would immediately lead to a significant economic downturn. Additionally, large-scale disruptions to the supply chain have not materialized at this point, and supply constraint issues are also limited. Based on these premises, it is clearly confirmed that even as downside risks to the economy and upside risks to inflation coexist, the relative weight of the latter is increasing.

In relation to this, the latest speech by Governor Ueda explicitly indicated two "points to monitor" regarding future monetary policy. Namely, whether the Japanese economy will deteriorate significantly under the Middle East situation and high crude oil prices, and whether the rise in prices will spread to a wide range of items and push up the underlying inflation rate.

On the economic front, the view was expressed that accumulated corporate profits and wage increases are functioning as support, and that production activity has maintained resilience partly because alternative procurement has progressed for raw materials with high dependence on the Middle East. He also indicated the view that, as these adjustments proceed, future downside risks to the economy will be minimized.

On the price front, he indicated the view that the pace of price pass-through stemming from higher crude oil prices is faster than before and that the effects are more likely to spread to a wide range of items. The speech emphasized vigilance toward the channel through which actual price increases push up expected inflation and cause underlying inflation to overshoot.

Based on these checkpoints, the overall judgment presented is that upside risks to prices are larger than downside risks to the economy and are also more likely to materialize sooner.

Price assessment: "Materialization of second-round effects"

The core of this speech was the clarification of the view that price increases associated with supply shocks are beginning to feed through to underlying inflation. Price increases caused by supply shocks are usually treated as temporary factors and, in principle, are not addressed by monetary policy. However, in a phase where firms' wage- and price-setting behavior becomes more active, price pass-through may proceed in a chain reaction and push up the underlying inflation rate itself. "There has been no clear disruption of supply chains, and greater emphasis should be placed on responding to the risk that prices will overshoot," a senior BOJ official stated.

Japan currently meets the conditions of sustained wage growth, accelerating price pass-through, and low real interest rates simultaneously, which is understood to be a state where such second-round effects are likely to occur. Observed indicators such as higher corporate goods prices and an upswing in market inflation expectations are also moving in a direction consistent with this recognition. Higher crude oil prices are no longer viewed merely as a transient shock, but are recognized as a channel that pushes up underlying inflation.

Exchange rates and inflation expectations form the "risk of policy delay"

The speech also explicitly described the channel through which delayed policy responses are reflected in market interest rates. It pointed out that if markets perceive that an appropriate policy response is not being taken in response to rising prices, long-term interest rates may overshoot. It also expressed the view that an upward shift in inflation expectations has contributed to the recent rise in long-term interest rates. This indicates the relationship in which, under accommodative financial conditions, a delay in policy response leads to an overshoot in long-term interest rates through inflation expectations.

Exchange rate developments can be placed in the same context. The fact that the yen's weakening trend has persisted despite a decline in crude oil prices and forex intervention is consistent with Japan's low real interest rates, and the movement is linked not only to external factors but also to monetary policy.

The depreciation of the yen not only pushes up prices through import prices, but also affects price pass-through and the formation of expected inflation. As a result, conditions remain in place in which upside risks to prices are likely to increase, and the timing of the policy response affects both exchange rates and market interest rates. Concerns about falling behind the curve are being formed amid this linkage among exchange rates, prices, and interest rates.

June rate hike should be understood in the context of "avoiding policy delay"

Based on the above, a June rate hike should be understood not so much as a response to an overheating economy, but in the context of avoiding a delay in the policy response. In the Governor's speech, it was made clear that if the response is delayed, the BOJ could later be forced to implement substantial rate hikes, placing a heavier burden on financial markets, the financial system, and the economy. For this reason, the speech strongly implied that proceeding with adjustments through gradual rate hikes would ultimately contribute to market stability.

That said, although voices within the government have also strengthened in favor of "standing by if the BOJ raises rates on its own responsibility" (*Nikkei*), the administration side appears to fundamentally remain reluctant to rate hikes.

Accordingly, the formation of interest rates after the speech will likely diverge in two directions depending on how markets perceive the policy response. If a rate hike is steadily implemented and perception forms that the policy response is not delayed, an upward revision to the terminal rate will be priced in mainly in the short-to-medium term zone, and the yield curve will flatten. On the other hand, if the rate-hike decision is delayed, or if a perception remains that the response to inflation is insufficient, the long-term sector will be pushed up against the backdrop of rising inflation expectations, and the curve will steepen. Yesterday's speech is seen as a communication aimed at convergence toward the former path, but depending on developments in exchange rates and inflation expectations, the dynamics of the latter path are also likely to remain in parallel.

Uncertainty over effectiveness of rate hikes: Can long-term interest rates and exchange rates be controlled?

However, even if a June rate hike is implemented, it is not clear whether it will directly lead to stability in long-term interest rates or exchange rates. In fact, there have been discussions within the BOJ about whether "long-term interest rates will rise as a result of a rate hike," and after the previous rate hike in December 2025, long-term interest rates did rise.

Regarding the recent rise in long-term interest rates, many have pointed out that risk factors such as inflation concerns and market views on fiscal policy have had a larger impact than forecasts for short-term interest rates. For this reason, while a rate hike pushes up short-term interest rates, it may also work in the direction of restraining an expansion in the term premium by curbing inflation expectations, but the magnitude of that effect is uncertain.

As the same applies to exchange rates, a single rate hike alone will not necessarily reverse the yen's depreciation trend. In addition to movements in US interest rates and global capital flows, market views on domestic real interest rates and the continuity of policy will continue to have an impact.

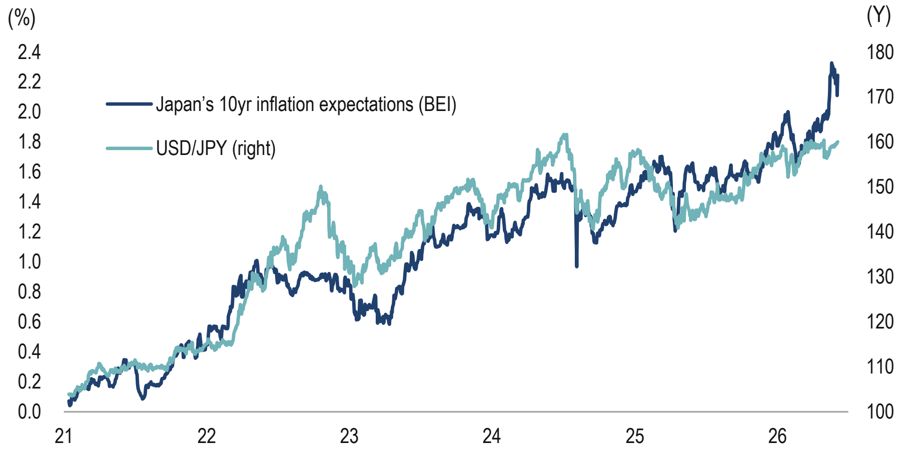
As a result, the focus surrounding a June rate hike will shift beyond whether it is implemented to what extent it contributes to stabilizing long-term interest rates and exchange rates. The BOJ will need to respond to both inflation expectations and long-term interest rates, including through a combination of rate hikes and its JGB purchase program, and the difficulty of policy management remains high.

Summary

Yesterday's speech by Governor Ueda is significant not just for whether it implies a June rate hike, but because it clarified the priorities for policy decisions under a supply shock. Even amid continued uncertainty over the Middle East situation, the speech indicated a stance of prioritizing upside risks to prices, while also specifically articulating the channels through which a delayed policy response could spill over into market interest rates and exchange rates.

As a result, the June MPM should be positioned not merely as a decision on whether to implement an additional rate hike, but as a phase for confirming whether the BOJ will prioritize avoiding falling behind the curve. Moreover, even after a rate hike, how long-term interest rates and exchange rates react will become the key focus and litmus test, and we will likely transition into a phase where the very effectiveness of monetary policy itself will be questioned by the market.

Japan's 10yr BEI, USD/JPY Rate



Source: Bloomberg; compiled by Daiwa.

IMPORTANT DISCLOSURES

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Ratings
Issues are rated 1, 2, 3, 4, or 5 as follows:
1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

Target Prices
Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

Disclosures related to Daiwa Securities
Please refer to https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings
This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at: https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/credit_ratings.pdf. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law
(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)
If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Investment Management Association of Japan, Type II Financial Instruments Firms Association, Japan Security Token Offering Association