Daiwa Securities

Economic Commentary (Jul BOJ MPM preview)

Policy rate likely to remain unchanged, but vigilance against upside inflation risks is unlikely to ease

- July meeting expected to keep policy rate unchanged
- Growth forecasts likely to be revised upward, while parts of the inflation outlook are likely to be revised downward
- Key focus regarding inflation will be the assessment of upside risks over the long term, rather than the baseline outlook

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Despite downward revisions to the inflation outlook, BOJ is expected to signal continued vigilance regarding upside risks

At the Monetary Policy Meeting (MPM) on 30-31 July, the BOJ is expected to decide to maintain its current monetary policy to assess the impact of past rate hikes, including the one at the June meeting, and the effects of the situation in the Middle East. Furthermore, in the *Outlook for Economic Activity and Prices* report (*Outlook Report*) to be released at the same time, it is highly likely that parts of the inflation forecasts will be revised. This will reflect (1) the decline in crude oil prices since April, (2) the government's electricity and gas subsidies during the summer, and (3) the recent subdued trend in consumer prices.

Specifically, we expect downward revisions to the forecasts for core CPI and core-core CPI for FY26, as well as that for core-core CPI for FY27. On the other hand, the forecast for core CPI for FY27 may be revised slightly upward, partly reflecting the fading impact of the downward pressure exerted by the electricity and gas subsidies.

Meanwhile, the economic outlook is likely to reflect the fact that the Japanese economy has remained more resilient than the BOJ projected in April, supported by factors such as expanding global demand for AI-related investment and progress in securing alternative supply sources in response to developments in the Middle East. In light of these developments, the growth forecasts for FY26 and FY27 are likely to be revised upward.

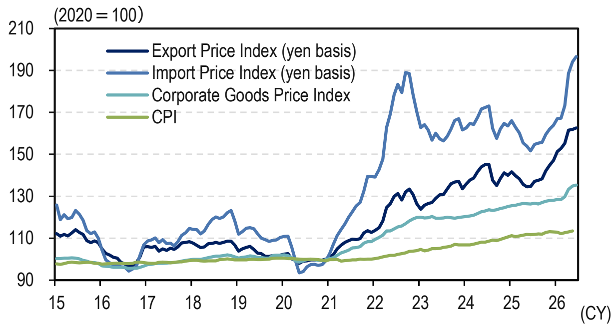
BOJ Policy Board Members' Projections (y/y %)

	Real GDP		Core CPI		Core-core CPI	
	Apr 2026*	**Jul 2026****	Apr 2026*	**Jul 2026****	Apr 2026*	**Jul 2026****
FY26	+0.5 %	**+0.7 %**	+2.8 %	**+2.5 %**	+2.6 %	**+2.4 %**
FY27	+0.7 %	**+0.8 %**	+2.3 %	**+2.4 %**	+2.6 %	**+2.5 %**
FY28	+0.8 %	**+0.8 %**	+2.0 %	**+2.0 %**	+2.2 %	**+2.2 %**

Source: BOJ; compiled by Daiwa.
**BOJ projections. **Our estimates for policy board member projections (highlighted in light blue).*

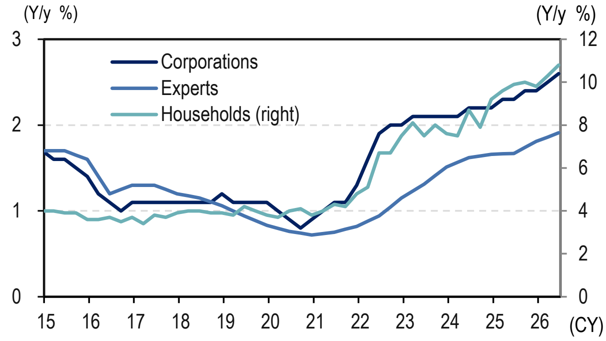
However, downward revisions to some inflation forecasts would not mean that upside inflation risks have receded. The revisions are expected to mainly reflect temporary factors, such as changes in crude oil prices and government subsidies. Meanwhile, given firms' proactive price-setting behavior, rising inflation expectations among households and corporations, and further yen depreciation, the risk of underlying inflation overshooting the BOJ's 2% price stability target may, if anything, have increased. In addition, the improved economic outlook is expected to exert upward pressure on prices by tightening supply/demand conditions.

Price Levels by Indicator



Source: BOJ, Ministry of Internal Affairs and Communications; compiled by Daiwa.
Note: The export price index, import price index, and corporate goods price index are based on all-commodity averages, while the consumer price index is based on the all-items index.

Inflation Expectations



Source: BOJ, Japan Center for Economic Research (JCER); compiled by Daiwa.

Indeed, the April *Outlook Report* noted that fluctuations in crude oil prices had become more likely to spill over into prices for broad range of goods and services, and that underlying inflation could be pushed higher by rising inflation expectations. Recent developments suggest that some elements of this risk scenario may be beginning to materialize.

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

- Moreover, considering the current situation of Japan's economy that, for example, firms' behavior has shifted more toward raising wages and prices compared with the period such as when commodity prices rose after Russia's invasion of Ukraine, it is possible that the rise in crude oil prices is passed on to the price of various goods and services more easily than before. Furthermore, attention should also be paid to the possibility that such moves have become more likely to lead to a pushing up of underlying CPI inflation through a rise in inflation expectations.

From this perspective, the forecast for core-core CPI in FY28 is likely to remain above 2%, and the BOJ is expected to express strong vigilance regarding upside inflation risks. Consequently, we expect the assessment of the balance of risks to economic activity to be revised to “generally balanced,” reflecting diminished concerns about downside risks, while the assessment that “risks to prices are skewed to the upside” is likely to be maintained.

Key point (1): Assessment of upside inflation risks

There will likely be no major change from the June meeting regarding the basic stance toward the conduct of monetary policy. While maintaining its policy of continuing to raise interest rates under accommodative financial conditions, the BOJ is expected to retain flexibility regarding the timing and pace of rate hikes as it assesses the effects of previous rate increases and the uncertainties surrounding developments in the Middle East.

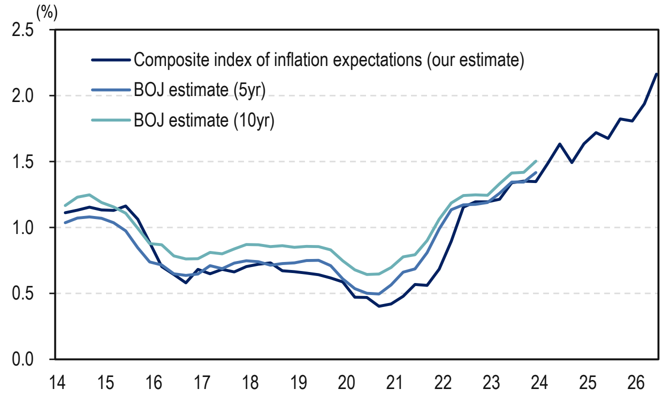
The key focus will be the BOJ’s assessment of upside inflation risks. On 22 July, Bloomberg reported that, according to BOJ officials, “underlying inflation is now quite close to the 2% price stability target” and that “there is an increasing need to pay attention to the possibility that it could rise above 2%.” Reuters also reported the BOJ’s view that it is important to “stabilize underlying inflation at around 2%.”

What is common to these reports is that the BOJ's focus is shifting from the phase of "raising the underlying inflation rate to 2%" to the phase of "stabilizing it around 2%." In other words, the BOJ's primary concern is moving from whether the underlying inflation rate will reach 2% to assessing the risk of it remaining above 2%.

This concern is not, however, new. The June statement referred to the risk that underlying inflation could overshoot, while the April *Outlook Report* indicated the need to confirm that inflation would become firmly established at around 2%. The July *Outlook Report* and Governor Ueda’s press conference are likely to reiterate this concern.

In particular, judging from the recent rise in inflation expectations, underlying inflation appears to be moving quite close to the 2% price stability target. This suggests a growing possibility that underlying inflation will reach around 2% at an earlier point within the previously projected period from the second half of FY26 through FY27.

Composite Index of Inflation Expectations



Source: BOJ, JCER, Bloomberg; compiled by Daiwa.
Note: Based on the BOJ's methodology, the first principal component was extracted from four combinations: households (quantitative and qualitative questions), corporations (Tankan), experts (ESP Forecast and inflation swaps). The mean and variance of each first principal component were standardized to match the average of the mean and the average of variance over the period of the ESP Forecast and inflation swaps. The simple average of the four series was calculated as the composite index of inflation expectations.

Accordingly, the July *Outlook Report* and Governor Ueda's press conference may include remarks suggesting that underlying inflation is closer to the 2% price stability target than before and that the timing of its reaching that level has moved forward within the previously projected time frame.

Key point (2) : Whether a rate-hike proposal is submitted and the policy board members' stances

At the July meeting, one or more hawkish policy board members may submit a proposal to raise the policy rate.

We believe that policy board member Hajime Takata takes the view that "it is necessary to bring the policy rate closer to the neutral rate as soon as possible and thereby ensure the flexibility needed to swiftly adjust the policy rate in either direction" (Summary of Opinions at the Jun MPM). The current policy rate remains below the BOJ's estimated neutral interest rate range of 1.1–2.5%, and there is a strong possibility that Takata favors an early rate hike toward the neutral rate. It should also be noted that, at the January 2026 meeting following the rate hike in December 2025, Takata proposed another rate hike on the grounds that upside inflation risks were high.

In his June speech, policy board member Naoki Tamura stated that "what I envisage as a baseline path is raising the policy interest rate by 0.25 percentage points at intervals of a few months toward the neutral interest rate level of 2%."He further indicated that, "If the materialization of upside risks to prices becomes more likely, I consider it necessary to accelerate the pace of rate hikes without hesitation." The possibility that he will submit a rate-hike proposal at the upcoming meeting therefore cannot be ruled out.

Even if one or more members were to submit a rate-hike proposal, this would not necessarily indicate that a policy change was imminent. Actual policy decisions are likely to be driven primarily by the BOJ leadership, particularly Governor Kazuo Ueda and deputy governors Shinichi Uchida and Ryozo Himino.

Nevertheless, if vigilance against upside inflation risks increases among policy board members, the future direction of monetary policy may become increasingly tilted toward further rate hikes. In this sense, another important focus at the July meeting will be how the policy board's overall risk assessment is changing.

Future rate hikes will hinge on whether upside inflation risks materialize

As discussed above, the BOJ is likely to leave the policy rate unchanged at the July meeting while maintaining its vigilance regarding upside inflation risks.

The key factor determining any additional rate hikes will be the extent to which upside inflation risks materialize through firms' pass-through of higher costs into prices, changes in inflation expectations, and exchange rate developments. Against this backdrop, the BOJ's focus is shifting from raising underlying inflation toward 2% to stabilizing it at around 2%. In future policy decisions, the assessment of upside inflation risks is likely to become even more important than the baseline outlook.

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