Daiwa Securities

Economic Commentary (Jul BOJ MPM)

BOJ stands pat but stays alert to upside inflation risk

- BOJ leaves monetary policy unchanged
- Medium- to long-term inflation forecasts unchanged; still alert to risk of inflation overshoot
- BOJ's focus shifting from achieving 2% to managing risk of overshoot

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BOJ stands pat, but remains hawkish on inflation

The Bank of Japan (BOJ) left the policy rate unchanged at its 30-31 July Monetary Policy Meeting (MPM). In the *Outlook Report* released alongside the decision, it also revised down some of its inflation forecasts to take account of the government's summer measures to ease the burden of energy costs (electricity and gas charges).

The more important takeaway is that the BOJ's medium- to long-term view on inflation remains hawkish. The *Outlook Report* judged that lower crude oil prices had reduced "the significant upside risks to prices" flagged in the previous edition, yet it kept the FY28 core-core CPI forecast at +2.2% y/y. Holding inflation above 2% even at the end of the projection period shows that the BOJ still expects considerable medium- to long-term inflationary pressure.

The section on the conduct of monetary policy also now explicitly names the risk of "underlying CPI inflation deviating upward to a level above the price stability target of 2 percent." The BOJ added the expansion in AI-related demand and developments in foreign exchange rates to the factors it will examine in considering the timing and pace of adjustment. Together, these suggest that the BOJ is more alert than before to factors that could push inflation higher.

The BOJ naturally maintains its stance of judging the timing and pace of rate hikes while examining economic and price conditions and the risks around them. These additions therefore do not in themselves imply that the BOJ will up the pace of rate hikes or bring forward its next hike.

At the same time, the gradual shift in how the BOJ frames the problem should not be overlooked. The focus until now has been on whether the 2% price stability target can be achieved sustainably. The question that is becoming increasingly important is how to manage the risk of inflation overshooting the 2% target.

That shift also came through at this meeting, where the vote was 8-1: Board member Hajime Takata proposed that the BOJ encourage the uncollateralized overnight call rate to remain at around 1.25%, considering that "the situation had shifted to a new phase in which the Bank needs to adopt a nimble approach in response to upside risks to prices caused by demand shocks stemming from overseas developments and to changes in overseas financial conditions."

Takata is well known as a hawk, so his dissent itself is no great surprise. However, it does reconfirm that at least one member of the Policy Board continues to favor a faster pace of policy normalization under current economic and price conditions.

Taking all of this together, the outcome reconfirms that the BOJ is strongly concerned about upside risks to inflation. We see no clear signal of a faster pace of hikes, but the BOJ's policy reaction function is steadily shifting toward risk management. We read the meeting as a continued signal that the BOJ will not rule out moving up its next rate hike to earlier than we previously assumed if upside risks to inflation emerge.

Economic outlook: BOJ assumes moderate growth

The BOJ's view of the economy also improved. In the *Outlook Report*, the medians of the Policy Board members' forecasts for real GDP growth were revised up to +0.6% for FY26 (from +0.5%) and +0.8% for FY27 (from +0.7%). The risk balance around the economic outlook, which the previous *Outlook Report* flagged as carrying significant downside risks, is now "generally balanced." We think this reflects companies' progress with securing alternative sources of supply and the resilience of the global economy, supported by growing AI-related demand.

We are nevertheless struck by how cautious the BOJ's FY26 growth forecast still is. The ESP Forecast (July 2026 survey) puts FY26 real GDP growth at +0.7%, slightly above the BOJ's +0.6%. We assume this reflects the BOJ expecting higher inflation in FY26 than economists do. The latest *Outlook Report* is also unlikely to fully incorporate the impact of the Kumamoto earthquake given that the full extent of the damage remains unclear.

However, there is no sign of significant pessimism about the medium- to long-term outlook. The BOJ's real GDP growth forecasts for both FY27 and FY28 are +0.8%, above the potential growth rate. This shows that, while acknowledging a temporary dip caused by higher crude oil prices, the BOJ still sees the underlying trend of the Japanese economy as one of moderate growth.

FY26-28 Forecasts of Majority of Policy Board Members (y/y %)

	Real GDP	CPI (all items less fresh food)	(Ref) CPI (all items less fresh food and energy)
FY26	+0.6 ～ +0.7 [+0.6]	+2.3 ～ +2.7 [+2.5]	+2.3 ～ +2.6 [+2.5]
As of Apr	+0.4 ～ +0.7 [+0.5]	+2.8 ～ +3.0 [+2.8]	+2.5 ～ +2.7 [+2.6]
FY27	+0.7 ～ +0.8 [+0.8]	+2.2 ～ +2.5 [+2.4]	+2.2 ～ +2.7 [+2.6]
As of Apr	+0.6 ～ +0.8 [+0.7]	+2.3 ～ +2.4 [+2.3]	+2.6 ～ +2.7 [+2.6]
FY28	+0.7 ～ +0.8 [+0.8]	+2.0 ～ +2.2 [+2.0]	+2.1 ～ +2.3 [+2.2]
As of Apr	+0.7 ～ +0.8 [+0.8]	+2.0 ～ +2.2 [+2.0]	+2.1 ～ +2.4 [+2.2]

Source: BOJ; compiled by Daiwa

Notes: (1) Figures in brackets indicate the medians of the Policy Board members' forecasts (point estimates).

(2) The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which they attach the highest probability of realization. These forecasts are then shown as a range, with the highest figure and the lowest figure excluded. The range does not indicate the forecast errors.

(3) Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

Distribution of Real GDP Forecasts (majority of policy board members)

(%)	FY26		FY27		FY28	
	Apr-26	Jul-26	Apr-26	Jul-26	Apr-26	Jul-26
0.4	2					
0.5	5			1		
0.6		7	2			
0.7	2	2	5	2	2	4
0.8			2	5	7	4
0.9				1		1
1.0						
1.1						
1.2						
Upside	1	2	2	2	0	1
Downside	5	2	2	1	0	1
Balanced	3	5	5	6	9	7

Source: BOJ; compiled by Daiwa.

Inflation outlook: Near-term price pressure eases, but BOJ stays alert to upside risk

The BOJ's inflation forecasts reflect a partial retreat in near-term inflationary pressure. It revised down its median FY26 core CPI forecast to +2.5% from +2.8%, reflecting (1) the government's summer subsidies for electricity and gas charges, (2) lower crude oil prices than in April, and (3) the recent subdued path of consumer prices. It revised up its FY27 forecast to +2.4% from +2.3%, reflecting base effects from the summer subsidies.

The BOJ's core-core CPI forecasts deserve the most attention. It revised down FY26 slightly to +2.5% y/y from +2.6%, but its forecasts from FY27 are broadly unchanged. What matters most is that the BOJ kept its FY28 core-core CPI forecast at +2.2% y/y even while judging that the significant upside risks to prices flagged in April had decreased. The fact that it expects inflation to remain above 2% even at the end of its projection period suggests that it continues to see considerable medium- to long-term inflationary pressure.

We think these forecasts reflect more aggressive corporate pricing behavior alongside concerns about yen weakness and growing AI-related demand. The *Outlook Report* states explicitly that "the rise in the prices of semiconductors and other items, reflecting the increase in global AI-related demand, and the recent depreciation of the yen are likely to lead to an increase in prices, mainly of durable goods." This suggests that the BOJ may now be more conscious of these factors as sources of upside price pressure than it was in April.

The risk assessment shows a similar tendency. Most Policy Board members still judge the risks to their FY26 and FY27 core CPI forecasts as skewed to the upside. Near-term inflationary pressure has eased somewhat on lower crude oil prices, but the BOJ's basic stance appears to still be vigilance about an inflation overshoot.

Overall, the latest *Outlook Report* is in line with the June MPM in showing concerns about downside risk to the economy receding while vigilance about upside risks to inflation remains strong.

One further point worth noting is the following new passage in the *Outlook Report*: "many have pointed out that investment has been constrained by factors such as the surge in material prices, in addition to labor shortages. Taking this into account, achieving price stability through the appropriate conduct of monetary policy is also important from the perspective of supporting the expansion of growth investment in Japan."

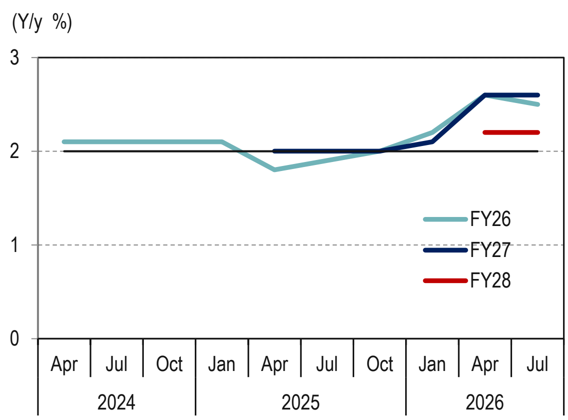
This passage matters as a message to the government. As the government pushes ahead with more growth investment and crisis-management investment to deliver a strong economy, the BOJ appears to be signaling that price stability is essential if that spending is to translate into sustainable growth.

Distribution of Core CPI Forecasts (majority of policy board members)

(%)	FY26		FY27		FY28	
	Apr-26	Jul-26	Apr-26	Jul-26	Apr-26	Jul-26
1.8						
1.9						
2.0					6	6
2.1				1	1	1
2.2			1	1	2	2
2.3		2	5	1		
2.4			2	3		
2.5	1	3		2		
2.6		2	1			
2.7		1		1		
2.8	5	1				
2.9	1					
2.9	2					
Upside	7	8	7	7	2	3
Downside	0	0	0	1	0	2
Balanced	2	1	2	1	7	4

Source: BOJ; compiled by Daiwa,

Core-core CPI Forecasts as of Each MPM (majority of policy board members)



Source: BOJ; compiled by Daiwa.

Governor Kazuo Ueda's press conference: How concerned is BOJ about inflation overshoot?

The MPM statement and *Outlook Report* both show that the BOJ remains alert to upside inflation risk, and implies that it will not rule out acting earlier than previously assumed should that risk emerge.

The focus at Governor Ueda's press conference will be how much vigilance he signals about this upside inflation risk. It will be an opportunity to gauge whether that risk is now higher than before, and how long the BOJ can afford to remain on hold in the face of it.

The current picture is that aggressive corporate pricing behavior, continued yen weakness, and growing AI-related demand are all amplifying upside inflation risk. The statement and the *Outlook Report* make clear that the BOJ still attaches considerable weight to this risk.

Meanwhile, the Kumamoto earthquake and swings in share prices argue for more caution in assessing the economic and inflation outlook. The impact of the earthquake in particular is highly uncertain, and it is hard to factor it directly into policy decisions at this stage.

That said, large-scale disasters of this kind generally have both positive and negative aspects: (1) supply constraints from damage to the capital stock and disruption to supply chains, (2) weaker demand as household and corporate sentiment deteriorates, and (3) higher demand from recovery and reconstruction. The earthquake will add to uncertainty for the time being, but it does not necessarily mean a delay to the BOJ's rate hiking path.

If the press conference is read as more dovish than expected, it could also weaken the yen and increase the very upside inflation risk the BOJ is guarding against. We think this strengthens the need for Governor Ueda to send a somewhat hawkish message at the press conference.

Main Contents of *Outlook Report*

● Baseline Scenario of the Outlook for Economic Activity	
Jul 2026	Japan's economy is expected to continue growing moderately, albeit at a decelerated rate, in fiscal 2026. This is because, although the rise in crude oil prices since early spring reflecting the impact of the situation in the Middle East is expected to push down economic activity, the economy is likely to be underpinned by factors such as the government's various measures and accommodative financial conditions, in addition to an increase in global AI-related demand. Japan's economic growth rate is likely to rise moderately from fiscal 2027 onward, since it is projected that the adverse effects of high crude oil prices will wane and that a virtuous cycle from income to spending will gradually intensify.
(Apr 2026)	Japan's economic growth is likely to decelerate in fiscal 2026, since the rise in crude oil prices reflecting the impact of the situation in the Middle East is expected to push down corporate profits and households' real income through factors such as a deterioration in the terms of trade. However, the economy is expected to continue growing moderately, albeit at a decelerated rate, since it is likely to be underpinned by factors such as the government's various measures and accommodative financial conditions, in addition to developments such as continued high levels of profits in the corporate sector. Japan's economic growth rate is likely to rise moderately from fiscal 2027 onward, since it is projected that the adverse effects of high crude oil prices will wane and that a virtuous cycle from income to spending will gradually intensify.
＜Risk balance＞	
Jul 2026	Risks to economic activity are generally balanced.
(Apr 2026)	Particularly for fiscal 2026 -- risks to economic activity are skewed to the downside.
● Baseline Scenario of the Outlook for Prices	
Jul 2026	The y/y rate of increase in the consumer price index (CPI, all items less fresh food) is likely to accelerate to a level clearly above 2 percent from the second half of fiscal 2026. This is because, with moves to pass on wage increases to selling prices continuing, the rise in crude oil prices to date is expected to push up prices, mainly of energy and goods, and the rise in the prices of semiconductors and other items, reflecting the increase in global AI-related demand, and the recent depreciation of the yen are likely to lead to an increase in prices, mainly of durable goods. Thereafter, with the waning of the effects of high crude oil prices, the rate of increase is expected to decline toward around 2 percent in the second half of the projection period. Meanwhile, with a sense of labor shortage continuing to be strong, it is projected that the mechanism in which wages and prices rise moderately in interaction with each other will be maintained, and that medium- to long-term inflation expectations will rise.
(Apr 2026)	The y/y rate of increase in the consumer price index (CPI, all items less fresh food) is likely to be in the range of 2.5-3.0 percent in fiscal 2026, as the rise in crude oil prices is expected to push up prices, mainly of energy and goods, with moves to pass on wage increases to selling prices continuing. Thereafter, with the waning of the effects of high crude oil prices, the rate of increase is expected to decline to the range of 2.0-2.5 percent in fiscal 2027 and to around 2 percent in fiscal 2028. Meanwhile, with a sense of labor shortage continuing to be strong, it is projected that the mechanism in which wages and prices rise moderately in interaction with each other will be maintained, and that medium- to long-term inflation expectations will rise.
＜Risk balance＞	
Jul 2026	Risks are skewed to the upside.
(Apr 2026)	Particularly for fiscal 2026, risks to prices are skewed to the upside.
● Conduct of Monetary Policy	
Jul 2026	Given that underlying CPI inflation has been approaching 2 percent and financial conditions have been accommodative, 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 examining the likelihood of realizing the baseline scenario of the outlook for economic activity and prices and the risks to the outlook, including the impact of the situation in the Middle East, the expansion in AI-related demand, and developments in foreign exchange rates. In particular, the perspective of stabilizing underlying CPI inflation at a level around 2 percent becomes important in order to keep the risk of underlying CPI inflation deviating upward to a level above the price stability target of 2 percent from materializing and thereby exerting an adverse impact on the economy afterward.
(Apr 2026)	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.

Source: BOJ; compiled by Daiwa.

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