Daiwa Securities

Daiwa's Economic View

BOJ July policy meeting and coordinated forex intervention

- "Patience" put to the test

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Movement toward incorporating exchange rates into policy decisions

At its 30-31 July Monetary Policy Meeting, the BOJ decided to keep its policy interest rate unchanged. Policy board member Hajime Takata proposed a 0.25% interest rate hike, but the proposal was rejected. It appears that the government and the BOJ carried out yen-buying interventions just before and after the meeting, causing the USD/JPY exchange rate to plummet (= yen appreciation) temporarily from around USD/JPY164 to the USD/JPY157 range. With monetary policy and foreign exchange intervention occurring in close succession, this meeting provided an opportunity to consider the BOJ's assessment of inflation, the government's response to yen depreciation, and the timing of future interest rate hikes as a single, integrated issue.

Foreign exchange is at the intersection of these factors. In the BOJ's July *Outlook Report*, global AI-related demand and exchange rates were added as new items to monitor. At his post-meeting press conference, BOJ Governor Kazuo Ueda also stated that, "From our next meeting onward we will discuss monetary policy management." Yen depreciation is not a market variable that lies outside the BOJ's purview. Rather, it is beginning to be incorporated into policy decisions as a factor impacting underlying inflation.

The yen-buying interventions, which are believed to have taken place just before and after the meeting, are also difficult to interpret as a standalone foreign exchange measure. The BOJ has explicitly stated that exchange rates are a factor in its policy decisions. The government is also stepping up its supply/demand measures, including intervention and statements pertaining to the Government Pension Investment Fund (GPIF), in order to stem the yen's depreciation. The government is running out of "patience." More than ever, the markets are now paying closer attention to monetary policy, foreign exchange intervention, and the government's response to yen depreciation.

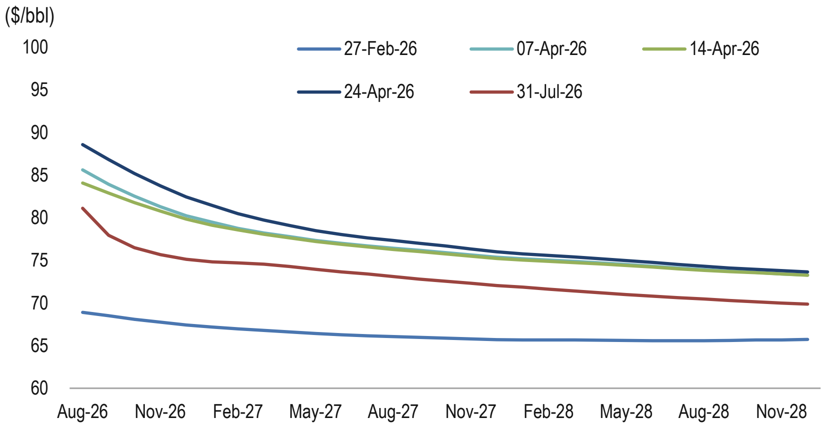
Changes seen in *Outlook Report*

In the July *Outlook Report*, the consumer price outlook for FY26 was revised downward against the backdrop of lower crude oil price assumptions and the resumption of electricity and gas rate subsidies. Meanwhile, the core-core CPI outlook did not deviate significantly. Indeed, it remained above 2% through the end of the projection period. The view that the underlying inflation rate will reach a level broadly consistent with the price stability target from the 2H FY26 through FY27 remains unchanged.

As of the April report, the upward pressure on prices caused by high crude oil prices and the situation in the Middle East were factors. However, this time the focus was on companies' more aggressive wage and pricing behavior, the rise in medium/long-term inflation expectations, AI-related demand, and exchange rates. Even though the CPI forecast has been revised downward, the BOJ's focus has shifted from temporary energy price factors to underlying inflation.

The CPI forecast for FY26 was revised downward, but the core-core CPI forecast remained unchanged. Excluding the downward effects from crude oil and electricity prices, the BOJ's view of underlying inflation has not retreated significantly. The risk of higher-than-expected prices is expanding from higher-than-expected temporary spikes driven by energy prices to inflationary expectations stemming from wages, the passing on of costs to higher prices, inflation expectations, AI-related demand, and yen depreciation.

Dubai Crude Oil Prices (futures curve)



Source: Bloomberg; compiled by Daiwa.

Added significance of AI-related demand and forex rates

The most significant change in the latest *Outlook Report* is that AI-related demand and exchange rates have been explicitly included in the description of monetary policy management. The explanation regarding "consider the timing and pace of monetary easing adjustments" included references to "expansion in AI-related demand" and "effects of developments in foreign exchange rates" in addition to the usual discussions on the situation in the Middle East. Furthermore, the report once again mentioned the "risk of underlying CPI inflation deviating upward to a level above the price stability target of 2%."

The notation that, "It will be important, from the perspective of sustainable and stable achievement of the price stability target, to examine whether it becomes anchored at a level around 2%" was also added. (The wording in the April report was "It will also be necessary to examine whether underlying inflation becomes anchored at a level around 2%.") Here, too, the key factors are AI-related demand and exchange rate fluctuations. The BOJ has started to view AI-related demand and exchange rates not merely as external factors, but as factors that could influence the timing and pace of adjustments to the degree of monetary easing.

◆ **Jul BOJ *Outlook Report* (31 Jul 2026): Conduct of Monetary Policy**

- As for the conduct of monetary policy, 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. With the price stability target of 2 percent, the Bank will conduct monetary policy as appropriate from the perspective of sustainable and stable achievement of the target.

A weak yen does more than simply drive import prices higher. It can also influence underlying inflation through firms' pricing behavior and inflation expectations. The fact that exchange rates were explicitly mentioned indicates that the BOJ has started to view yen weakness more clearly as a risk to underlying inflation. Depending on exchange rate fluctuations, we need to be aware of the possibility that interest rate hikes could be moved forward.

The same point was raised during discussions at the meeting. Monetary Policy Board member Takata proposed raising interest rates on the grounds 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." Even though this statement reflects the opinion of a single Policy Board member, the "demand shocks stemming from overseas developments" is believed to refer to AI-related demand, while the "changes in overseas financial conditions" is thought to refer to the weak yen and changes in overseas yields. There is some overlap with such fields as AI-related demand and exchange rates, which were added in the *Outlook Report*.

The July *Outlook Report* also touched on the relationship between price stability and growth investments. Price stability was identified not only as a means of protecting household purchasing power, but also as an issue closely tied to corporate investment decisions and efforts to strengthen supply capacity. We can also discern an intention to explain monetary policy not as something at odds with the government's growth strategy (growth investments), but rather as a factor that helps stabilize the investment environment.

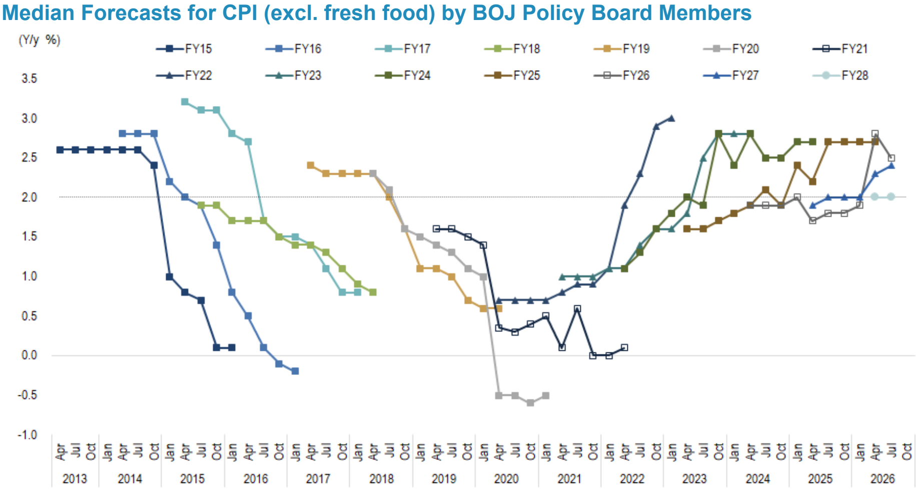
Governor Ueda repeatedly said, "From our next meeting onward"

BOJ Governor Kazuo Ueda maintained his view that monetary conditions remain accommodative and that more time is needed to assess the effects of the rate hikes so far. Meanwhile, while keeping a close eye on the foreign exchange market and the situation in the Middle East, he repeatedly stated that the Bank would discuss the conduct of monetary policy "from our next meeting onward." He seemed to have left open the possibility of a rate hike at the September meeting.

Ueda also went further to provide his recognition of price risks. He stated that, "Many members of the Policy Board have a fairly high inflation outlook and risks are skewed toward the upside." He also added, "We will take that into account when we hold future policy meetings." Furthermore, as the underlying inflation rate is approaching the 2% target, he also said, "We must scrutinize the risk of higher-than-expected price pressures more closely than ever before."

Regarding the pace of interest rate hikes, Ueda also said, "If we determine that monetary conditions are excessively accommodative, there is a chance we could speed up the pace of interest rate hikes." He also acknowledged that if policy responses are delayed, the Bank may be forced to implement rapid and substantial interest rate hikes, which could negatively impact the economy. Overall, this risk assessment suggests that the BOJ's policy assessment is shifting its focus from downside risks for the economy to higher-than-expected inflation risks.

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



Source: BOJ; compiled by Daiwa.

Currency intervention buys time for monetary policy

The government and the BOJ apparently carried out coordinated yen-buying interventions just before and after the July meeting. On 30 July, the USD/JPY exchange rate fell sharply from the USD/JPY162 range to a low USD/JPY157 range. Yen buying continued on 31 July as well. The

Japanese government and the BOJ are reported to have carried out yen-buying interventions early on 1 August, marking the second consecutive day of intervention during US trading hours.

US involvement was particularly apparent during this intervention. In addition to the US Treasury Department issuing an advance notice to financial institutions, the British newspaper *Financial Times* reported that the New York Fed had purchased yen. According to Reuters, US Treasury Secretary Scott Bessent carried a memo into a cabinet meeting that proposed the US should spend five billion to ten billion dollars to buy Japanese yen. There is a growing perception among market participants that, if the coordinated intervention is true, it would have been an unusual move.

Atsushi Mimura, Vice Minister of Finance for International Affairs (Chief Currency Diplomat) at MOF, even said, "We understand that we are receiving support from US authorities that goes beyond mere moral support." It appears that this intervention was not merely a reaction to the yen's weak level, but was intended to demonstrate to the market the depth of policy measures, including US involvement, aimed at halting the yen's decline.

That said, yen-buying intervention alone only has limited power to reverse the yen depreciation trend. While currency intervention can cause significant market fluctuations over the short term, unless the structural factor of the interest rate differential changes, downward pressure on the yen is likely to again intensify. This round of yen-buying intervention can be viewed as a policy designed to buy time until monetary policy and market conditions change.

In particular, given that hawkish members of the FOMC are openly advocating that the current policy is "not sufficiently tight," upward pressure on US interest rates, and, by extension, downward pressure on the yen, is unlikely to ease unless Fed Chairman Kevin Walsh clarifies the Fed's reaction function.

Unless there are significant changes in the underlying macroeconomic conditions, market forces are likely to return to their previous trends as soon as the intervention effects have subsided. With the BOJ carrying out intervention immediately after explicitly stating that exchange rates would be a catalyst for its policy decisions, the gap between its foreign exchange response and its monetary policy response has narrowed. This intervention has bought some time and the next focus will be on how the BOJ utilizes that time.

Administration's sense of crisis as evidenced by coordinated intervention

The response on the part of the government is also spreading. Starting with Finance Minister Satsuki Katayama's remarks on 10 July regarding an increase in domestic asset investments within GPIF, a series of similar statements followed from other government officials. The fact that the government brought up GPIF indicates that the administration is deeply concerned, not only about the weak yen, but also about rising long-term yields.

There are limits to MOF's currency intervention. While yen-buying interventions using foreign exchange reserves may be effective over the short term, their effects are unlikely to last as long as interest rate differentials persists. The remarks pertaining to GPIF reflect the government's strong stance on curbing both yen depreciation and rising long-term yields, including means other than currency intervention.

After that, the government's response entered a more proactive phase. The *Nikkei* reported that, on 31 July, the Japanese and US governments carried out coordinated intervention to buy the yen. According to that report, Finance Minister Katayama plans to explain a series of measures to correct the weak yen (including currency intervention) on 3 August. A joint statement between Japan and the US is reportedly being finalized. Reuters and Bloomberg have also reported that Japan's MOF is making arrangements to explain the efforts by Japan and the US to correct the weak yen. Furthermore, according to Reuters, one government official said, "The operation is still underway." Also, according to Kyodo News, a Japanese government official indicated that Japan and the US intend to continue coordinating their response after the start of the week, saying, "It might turn out to be something that surprises everyone." Taking these reports as a whole, it is highly likely that this response is not a one-off market intervention, but rather is part of a series of policy measures in which Japan and the US are working together to bolster the yen.

Also, during the early hours of 1 August, MOF posted that, "Japan's monetary authorities have a broad range of tools available to address market liquidity needs." This is a means of raising dollar funds using US Treasury bonds as collateral. This is seen as an effort to signal to the market that the government can raise dollar funds without selling US Treasury bonds, thereby enabling it to continue its yen-buying interventions. It is important that a message was sent to the market, not only through the currency intervention itself, but also by signaling that authorities have the capacity to intervene further. For the time being, "It is not worth fighting the authorities."

This coordinated intervention is difficult to view as merely a foreign exchange policy measure. Indeed, the *Nikkei* reported that the US side was also concerned that a weak yen and a strong dollar would undermine the effectiveness of US trade policy, adding that there was apprehension that Japanese market turmoil could spill over into the US Treasury market. Reuters also reported that if Japan is unable to stem declines for the yen and JGBs, market turmoil could spread, potentially leading to higher US Treasury yields. Halting yen depreciation is becoming an issue that concerns not only domestic price stability in Japan, but also the stability of financial markets in both Japan and the US.

We have previously pointed out that, amid the ongoing yen weakness, it is not only the BOJ's "patience" that is being tested, but also the government's "patience." Looking back at the sequence of events, from the GPIF statement to coordinated intervention, hints of additional measures, and the release of information designed to signal the government's capacity for further intervention, it appears that its "patience" had already neared its limit. The response this time was not sudden. It is more natural to view this as a result of the government gradually increasing its vigilance regarding both the weak yen and rising long-term yields.

Difficult to treat Sep BOJ meeting as just a stepping stone

The main scenario at this juncture is an interest rate hike in October. The BOJ has not concluded that the underlying inflation rate has reached 2% and it maintains its view that it still needs to assess the cumulative effects of interest rate hikes.

Meanwhile, at the July meeting, AI-related demand and exchange rates were added as key items within policy decisions and the phrase, "There is a risk that underlying inflation will deviate upward to a level above the price stability target of 2%" was mentioned again. Ueda also noted that many board members hold a relatively high outlook for prices and that risks are skewed toward the upside. Furthermore, he repeatedly used the phrase, "from our next meeting onward" and also mentioned "If we conclude that monetary conditions are excessively accommodative, there is a chance we could speed up the pace of interest rate hikes."

The July meeting suggested that the focus of policy decisions is shifting from the risk of an economic downturn to the risk of higher-than-expected inflation. For now, the government will likely do whatever it can to curb both rising long-term yields and a depreciating yen. However, continuing to curb yen depreciation through currency intervention alone is not easy. If the yen continues to weaken, market attention will turn not only to currency intervention, but also to the BOJ's policy response.

At its July meeting, the BOJ explicitly incorporated exchange rates into its policy considerations. The government has also been expressing growing concern about both yen weakness and rising long-term yields through coordinated intervention and statements pertaining to GPIF. Depending on trends for exchange rates and long-term yields, a rate hike in September is no longer a risk that can be ignored. The market needs to pay closer attention to not only the October meeting, but to the September meeting as well.

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