Daiwa Securities

Daiwa's Economic View

Is BOJ moving toward back-to-back rate hikes?

- We maintain our forecast for rate hikes in September and December, but will reassess the pace after the policy rate reaches 1.50%

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According to a Bloomberg report yesterday citing people familiar with the matter, the BOJ is likely to raise its policy rate by 25bp to 1.25% at its September Monetary Policy Meeting (MPM). Economic activity and prices have generally been developing in line with the BOJ's outlook, and the report indicated that officials see little need to increase the size of the rate hike, as "there has been no major change in the situation that would require opting for a larger move of half a percentage point." Expectations of a 50bp rate hike, which emerged following comments by Policy Board Member Hajime Takata, are likely to recede following this report.

Meanwhile, the BOJ has not ruled out the possibility that further rate hikes will be necessary after the September move. To prevent the underlying inflation rate from overshooting 2%, the BOJ reportedly believes that it will be necessary to adjust the pace of rate hikes flexibly in response to developments in economic activity and prices, while carefully assessing the effects of the rate hike. This wording makes it difficult to conclude that the BOJ's leadership currently intends to implement back-to-back rate hikes in September and October. However, the pace at which the BOJ pursues further rate hikes, while maintaining a certain interval between moves, could be faster than previously.

We have thus far forecast that the BOJ will raise the policy rate to 1.25% in September and to 1.50% in December. The latest report is more consistent with our existing forecast of another rate hike before year-end than with the view that the next rate hike after September will come in January or later. What now needs to be reconsidered is the pace of rate hikes after the policy rate reaches 1.50%.

Background to expectations for back-to-back rate hikes

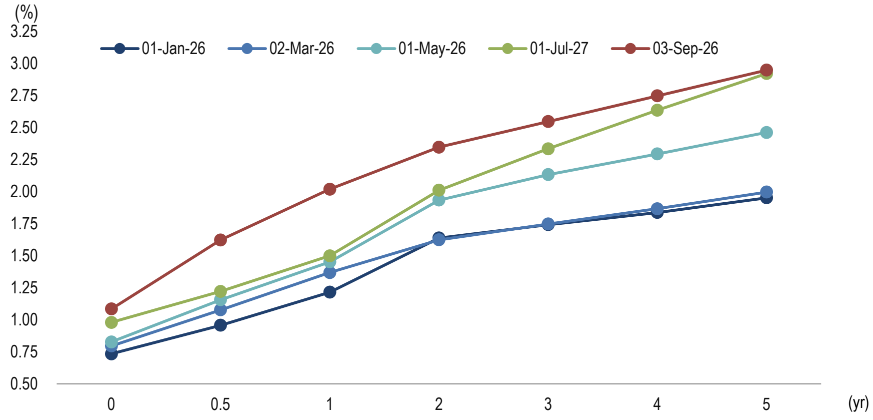
In a speech and subsequent press conference, Policy Board Member Takata said that 2026 marked "a change in phase and the beginning of a new regime." With the global monetary policy cycle shifting from rate cuts to rate hikes, amid an AI-led demand boom, fiscal support for economic activity, and inflationary pressures stemming from developments in the Middle East, he explained that "the situation is no longer one in which action is taken once every six months, or twice a year, as in the past, and a nimble response to the new environment is required."

Regarding the interval between rate hikes, Takata also said that "the very concept of intervals such as every six months or twice a year" was a feature of the previous environment, adding that, depending on circumstances, "back-to-back rate hikes could result." Regarding the size of rate hikes, he also indicated that the BOJ would need to consider "a broad range of options," rather than limiting itself to the previous increment of 25bp.

Following Takata's comments, the probability of a September rate hike priced into the OIS market rose to around 97%, while the market also priced in around a 25% probability of back-to-back rate hikes in September and October. The yen appreciated, while the yield curve flattened as superlong yields declined. In effect, expectations that the BOJ would move to address its behind-the-curve position, triggered by Takata's speech, led to yield-curve flattening and yen appreciation.

We share Takata's concerns regarding changes in the global interest rate environment and a rise in Japan's neutral rate driven by external factors. However, Takata is one of the most hawkish members of the BOJ's Policy Board, and his comments cannot be equated with the policy stance of the BOJ's leadership or the Policy Board as a whole.

Market Expectations for Policy Interest Rate



Source: Bloomberg; compiled by Daiwa.

Further rate hikes while assessing their effects

While the latest report citing people familiar with the matter indicated that a 25bp rate hike is likely at the September meeting, it clearly played down the likelihood of a 50bp hike, stating that "there has been no major change in the situation that would require opting for a larger move."

Regarding the period after the September rate hike, the report said that the BOJ would continue to address upside risks to inflation, while carefully assessing the effects of the rate hike and flexibly managing the pace of further increases depending on economic activity and prices. It takes time for the effects of a rate hike to feed through to economic activity and prices. The explanation that the BOJ will make its next decision after assessing the impact of the preceding rate hike suggests a policy approach under which further hikes are implemented while maintaining a certain interval between moves.

Takata also explained that, because it takes a certain amount of time for the effects of rate hikes to emerge, the BOJ needs to assess the situation carefully at each meeting, taking the relevant time lags into account. Although he did not rule out the possibility of back-to-back rate hikes in principle, he did not suggest that the BOJ would mechanically continue raising rates without assessing the effects of its policy actions.

This policy approach is consistent with our existing forecast for rate hikes to 1.25% in September and 1.50% in December. In the interest rate swap market, the probability of a 25bp rate hike in September is now just under 100%, while the probability of the subsequent rate hike occurring by December is priced at more than 80%, with such a move fully priced in by January 2027.

Pace of rate hikes after the policy rate reaches 1.50%

We expect rate hikes to continue after the policy rate is raised to 1.25% in September and 1.50% in December, ultimately taking the policy rate to around 2%. Until now, however, we had assumed that, once the policy rate reached 1.50%, the BOJ would need more time to assess the cumulative effects of its rate hikes and that the pace of tightening would therefore become somewhat more gradual. The latest report, however, also suggests that our assessment of the likely pace of tightening may need to be reconsidered.

The BOJ cannot avoid paying attention to upside risks to consumer prices, including the yen's depreciating trend. With the underlying inflation rate approaching 2%, companies continue to aggressively pass higher costs through to prices, including service prices. The BOJ has reportedly not ruled out the possibility that further rate hikes will be needed after the September move and intends to manage the pace flexibly depending on economic activity and prices.

If, after raising the policy rate to 1.25% in September and 1.50% in December, the BOJ also implements further rate hikes in March and June 2027, the policy rate will reach 2% in June 2027. We have regarded such a path, involving rate hikes once every three months until the policy rate reaches 2%, as a risk scenario. However, in light of recent market pricing and the latest report citing people familiar with the matter, the likelihood of this scenario is increasing. Our view that the interval between rate hikes will become somewhat longer after the policy rate reaches 1.50% needs to be reconsidered.

Domestic and external conditions supporting the pace of rate hikes

The latest report indicates that the BOJ remains alert to upside inflation risks against the backdrop of yen depreciation and companies' price pass-through. It also reportedly sees a need to bear in mind that, if it were to forgo the September rate hike currently priced in by the market, the yen could depreciate further, increasing upside risks to inflation. If similar inflationary pressures persist after the September rate hike, the BOJ will have limited scope to lengthen the interval before its next move.

In yesterday's *Daiwa's View:10-year JGB yield of 3% as stepping stone*, we argued that it is insufficient to explain the rise in Japan's long-term yields solely in terms of domestic fiscal conditions and the supply/demand balance for JGBs. Rising expectations for neutral interest rates, particularly in the US, are pushing up long-term yields globally, with the effects also feeding through to Japanese yields.

Takata also indicated that assumptions applicable to a "large country" such as the US are less likely to hold in Japan and that, because Japan is more susceptible to external influences, neutral rate estimates based exclusively on domestic factors should not be treated as an absolute benchmark. He also said that Japan's current real interest rate remains considerably low and that the policy rate needs to be moved closer to the estimated range for the neutral interest rate.

While monetary policy normalization is progressing, there has been no move to adjust the stance of fiscal policy. If fiscal policy continues to support demand and inflationary pressures persist through yen depreciation and companies' price pass-through, monetary policy will need to play a larger role in achieving price stability. It is therefore necessary to consider the possibility that the BOJ will maintain the size of each rate hike at 25bp and continue raising rates approximately once every three months while assessing the effects of its policy actions.

Not back-to-back rate hikes, but a faster pace of tightening

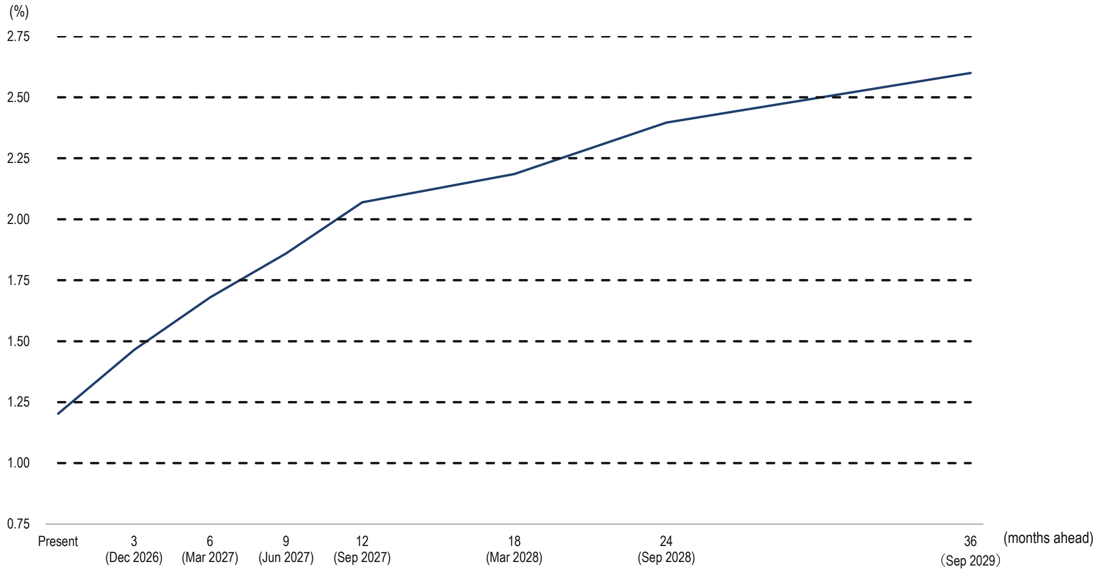
The latest report citing people familiar with the matter indicated that the BOJ is likely to raise the policy rate by 25bp at its September meeting, while also conveying the view that circumstances do not require a 50bp rate hike. It also indicated that the BOJ has not ruled out further rate hikes after the September move and will flexibly manage the pace of tightening depending on economic activity and prices, while carefully assessing the effects of its policy actions.

Nevertheless, given the wording "while carefully assessing the effects of the rate hike," it is difficult to conclude that the BOJ's leadership currently intends to implement back-to-back rate hikes in September and October. The report also played down expectations of a 50bp rate hike that had emerged following Takata's comments.

There is an increasing likelihood that we will revise our existing view regarding the pace of rate hikes after the policy rate reaches 1.50%. Given the BOJ's continued vigilance regarding upside inflation risks and its stance of not ruling out further rate hikes, we need to attach greater weight than before to the possibility of additional rate hikes in March and June 2027. Of course, the pace of rate hikes could be affected by exchange rate developments, the US monetary policy environment, and the fiscal policy stance of the Takaichi administration.

Our current assumption is that the BOJ will not move toward back-to-back rate hikes. However, the probability is increasing that it will raise the policy rate to around 2% at a faster pace than we previously assumed, while allowing for intervals between rate hikes to assess the effects of its policy actions.

Market Pricing of Rate Hikes



Source: Bloomberg; compiled by Daiwa.

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