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Daiwa's View

Sep BOJ Monetary Policy Meeting: A shift in the policy phase

- From reaching 2% inflation to stabilizing it at 2%
- Responding symmetrically to upside and downside risks
- Next rate hike expected in Dec

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Governor Ueda explicitly signals a "shift in the policy phase"

At its September meeting, the BOJ raised its policy rate to 1.25%. At the press conference, Governor Kazuo Ueda explained that, until now, with the underlying inflation rate below 2%, the aim of near-term monetary policy had been to raise the underlying inflation rate. Now that the underlying inflation rate is approaching 2%, the challenge for monetary policy has become to stabilize it at around 2% while avoiding an overshoot that could subsequently adversely affect the economy. He therefore stated that "the policy phase has changed."

Regarding this shift, Governor Ueda explained that "Japan's underlying inflation has moved closer to 2% from below that level, and the aim of monetary policy will be to stabilize it there." The shift in the policy phase was not triggered by the policy rate reaching 1.25%. Rather, the shift means that underlying inflation is approaching 2% and that it has become necessary to respond symmetrically to both upside and downside risks.

This assessment did not emerge suddenly at the latest meeting. Deputy Governor Ryozo Himino had already used the term "shift in the policy phase" in a speech shortly before the meeting. The Summary of Opinions from the July meeting also included the view that the focus of monetary policy had shifted from "lifting underlying CPI inflation to 2 percent" to "avoiding a further overshoot in underlying CPI inflation."

The BOJ's policy assessment has been consistent across the Summary of Opinions from the July meeting, Deputy Governor Himino's speech, and Governor Ueda's press conference following the September meeting. This represents a transition from a policy aimed at bringing inflation up to the target to one aimed at stabilizing it at around 2%, in other words, re-anchoring inflation at 2%.

A new phase with greater attention to upside inflation risks

Under the BOJ's policy approach to date, because the underlying inflation rate had remained below 2%, relatively greater emphasis had been placed on downside risks to inflation. Even when upside risks materialized and pushed up underlying inflation, such upward pressure served to bring it closer to 2%. Now that the underlying inflation rate is approaching 2%, the same upward pressure could lead to inflation remaining persistently above 2%.

Governor Ueda explained that rate hikes had proceeded at a somewhat gradual pace because the BOJ had, in effect, placed greater weight on downside risks, but that going forward it would "determine the timing and pace of interest rate changes while assessing risks symmetrically." This represents a transition to a policy approach that does not place less emphasis on downside risks but instead assigns equal weight to upside risks.

Behind this shift are rising inflation expectations, the wage-price cycle, and changes in corporate price-setting behavior. Companies have become increasingly willing to pass higher costs on to selling prices rather than absorb them. At the latest press conference, the BOJ also indicated that consumer price data for June through August showed that the pass-through from corporate goods prices to consumer prices was progressing in the categories in which such pass-through had been expected.

In such an environment, exogenous inflationary pressures, such as higher commodity prices and exchange rate movements, are more likely to feed through to underlying inflation via price increases across a broad range of items and rising inflation expectations. In "*Why is BOJ concerned about upside risks to inflation?*," the author pointed out that the BOJ had become increasingly vigilant about upside risks against the backdrop of changes in corporate price-setting behavior and inflation expectations. The assessment presented at the latest press conference is consistent with the concerns the author has raised to date.

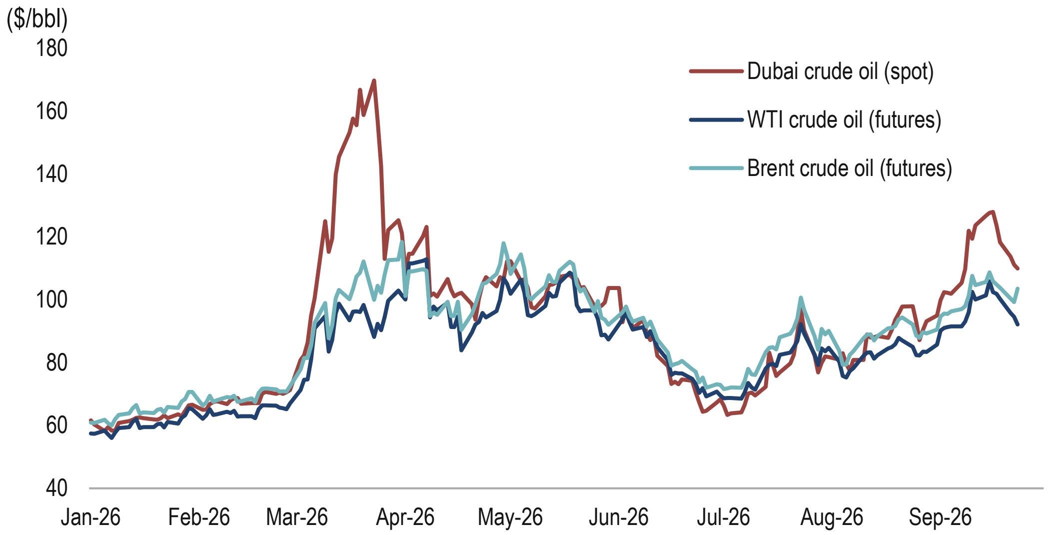
Regarding the possibility of being forced to implement substantial or consecutive rate hikes, Governor Ueda stated that the BOJ would "carefully consider the appropriate course of action and make various preemptive adjustments to avoid such a situation." The latest rate hike therefore has a preemptive dimension intended to avoid abrupt policy adjustments later.

Higher crude oil prices and *Outlook Report*

Governor Ueda cited the following changes since the July meeting: the situation in the Middle East has worsened in a way that increases upside risks to inflation; strong AI-related demand has persisted longer than expected; medium- to long-term inflation expectations have remained at their elevated levels; and strong wage data have continued. He explained that these developments had strengthened the BOJ's assessment that the underlying inflation rate was converging toward 2%.

Currently, the spot price of Dubai crude oil, which has a significant impact on the Japanese economy, is higher than previously expected. Higher commodity prices are generally regarded as a temporary supply shock. In an economy where companies are increasingly passing higher costs on to prices, however, higher crude oil prices are more likely to feed through from corporate goods prices to consumer prices and also affect underlying inflation.

Crude Oil Prices



Source: Bloomberg; compiled by Daiwa.

Governor Ueda explained that, if the rise in crude oil prices in early spring was the first wave, a second wave of recent increases in oil-related prices had emerged while the impact of the first wave was still being passed through to consumer prices. His assessment was that, if the situation in the Middle East persisted, it could push up corporate goods prices again and then feed through to consumer prices.

The effects would spread further if, in addition to companies passing higher costs on to selling prices, companies that had previously refrained from raising prices also began revising their prices in response to higher crude oil prices. When inflation expectations are not sufficiently anchored, attention must also be paid to the channel through which a supply shock could translate into higher underlying inflation.

If crude oil prices remain elevated, the likelihood of upward revisions to the core CPI forecasts for FY26 and FY27, relative to the July forecasts, will increase in the *Outlook Report* to be released after the next meeting in October. The BOJ did not postpone its decision until those revisions could be confirmed. Instead, it raised rates in September based on changes in inflation expectations, wages, crude oil prices, and price pass-through.

Revision of the Funds-Supplying Operations to Support Financing for Climate Change Responses

At the latest meeting, the BOJ also decided unanimously to revise the framework of the Funds-Supplying Operations to Support Financing for Climate Change Responses. The loan rate was changed from a fixed rate to a floating rate, and upper limits of Y50tn on the total lending and Y10tn per counterparty were introduced.

The facility was introduced in 2021 to support financial institutions' investment and lending aimed at addressing climate change. However, as the BOJ continued to raise its policy rate, the facility's monetary policy implications also changed. Under the previous framework, financial institutions were able to obtain one-year funding at a fixed rate based on the policy rate at the time of loan disbursement, making the facility an advantageous source of term funding in an environment where further rate hikes were expected. Amid intensifying competition for deposits and demand for an alternative funding source following the termination of the Fund-Provisioning Measure to Stimulate Bank Lending, the outstanding balance of the facility had expanded to approximately Y25tn.

Governor Ueda explained that the latest revision was intended to achieve both "the smooth conduct of market operations" and "stable support for efforts to address climate change." Regarding the Y50tn cap, he stated that it was a reasonable level based on an extrapolation of the facility's use to date and was not intended to significantly constrain climate-related lending.

If the BOJ had continued to raise rates while maintaining the previous framework, fixed-rate funding through the facility would have become increasingly advantageous as market and deposit rates rose, thereby increasing the facility's monetary easing effect. As a result, climate-related investment and lending alone could have benefited from relatively accommodative financial conditions, potentially distorting resource allocation and partially offsetting the effects of policy rate hikes.

With the introduction of a floating rate, further rate hikes will also be reflected in the facility's loan rate. The introduction of caps on total lending and the amount available to each counterparty will also help curb growth in the facility's outstanding balance. This will also enhance consistency with the reduction in the BOJ's balance sheet resulting from lower JGB purchases.

The latest changes do not represent a reduction in support for efforts to address climate change. Rather, they are intended to redesign a framework introduced during the monetary easing phase to suit the normalization phase, while maintaining that support. The "shift in the policy phase" is beginning to extend beyond the policy rate to the BOJ's funds-supplying framework and balance sheet management.

Gauging the neutral rate through financial conditions

Governor Ueda explained that financial conditions remained "accommodative" even after the policy rate had been raised to 1.25%, although policy rate hikes were gradually reducing the degree of monetary accommodation. Rather than assessing financial conditions solely on an aggregate basis, the BOJ examines them through multiple channels, including interest rates, bank lending, and asset markets.

At the press conference, Governor Ueda explained: "We broadly assess financial conditions from two or three perspectives. The first is interest rates, the second is how the bank lending channel is functioning, and the third is asset markets, including stock prices and foreign exchange rates." Of these, he assessed conditions through the long- and super-long-term interest rate channels as having "tightened considerably," while conditions through the bank lending and asset market channels remained "somewhat accommodative."

This framework is also directly relevant to the debate over the neutral rate. The neutral rate is an important concept for assessing the degree of monetary accommodation, but it is difficult to determine accurately in advance. The BOJ is seeking to gauge how accommodative its current policy stance is not only by looking at the gap between the policy rate and the estimated neutral rate, but also by examining changes in the various channels that constitute financial conditions.

The cumulative effects of the rate hikes implemented to date appear to be gradually emerging. In addition to changes in lending terms and a shortening of maturities on newly issued corporate bonds, the impact of higher interest rates has also begun to vary by industry and company size. At the same time, corporate earnings and demand for funds remain firm, while interest rates on the outstanding stock of borrowing remain low. Long-term interest rates have already risen considerably, but overall financial conditions, including bank lending and asset prices, are considered to remain supportive of the economy.

Governor Ueda stated, "We will closely monitor financial conditions, including the impact of the cumulative effects of past rate hikes." Because it takes time for changes in the policy rate to feed through to lending rates and corporate behavior, it is necessary to assess banks' actual lending stance and corporate funding conditions through interviews with firms and other means, as well as through published statistics.

At the same time, Governor Ueda stated that the BOJ also needed to avoid the adverse consequences of raising the policy rate too rapidly and thereby triggering "substantial adjustments" in bank lending and asset prices. The latest shift in the policy phase does not imply a mechanical acceleration in the pace of rate hikes. Monetary policy must strike a balance between addressing upside inflation risks and avoiding an abrupt tightening of financial conditions.

Monetary policy outlook

Governor Ueda stated that "given that financial conditions are accommodative, the next move will basically be a rate hike," and explained that the pace and size of future rate hikes would be determined in light of developments in upside inflation risks. At the same time, he indicated that the BOJ would assess upside and downside risks symmetrically in determining the timing and pace of interest rate changes. He did not rule out consecutive rate hikes or a 50bp rate hike, explaining that whether substantial or consecutive rate hikes would become necessary would depend on the risk of inflation rising significantly above the target.

At the same time, the BOJ does not believe that it should simply proceed slowly. Governor Ueda stated that it is necessary to "conduct a thorough analysis and respond at the appropriate time, including by changing policy." Data dependence does not mean postponing decisions. Rather, it means changing policy in a timely manner based on the information available.

With underlying inflation approaching 2% and overall financial conditions remaining accommodative, further rate hikes represent the baseline scenario. However, accelerating the pace further through consecutive rate hikes would send the market a stronger signal about the future path of interest rates than quarterly adjustments would.

Given the continued uncertainty surrounding the level of the neutral rate, and the fact that financial conditions have already tightened to a considerable extent through long- and super-long-term interest rates while bank lending and asset markets remain accommodative, consecutive rate hikes would not necessarily be consistent with the BOJ's current cautious approach. It would theoretically be possible to move the policy rate to a higher level through consecutive hikes and then rapidly slow the pace of rate increases. Such an approach, however, would entail the risk of an overshoot in interest rates and increased market volatility.

The latest "shift in the policy phase" is effectively consistent with a policy path under which the degree of monetary accommodation is adjusted at a roughly quarterly pace. The policy objective is no longer to raise the inflation rate, but to stabilize it at around 2% and prevent it from overshooting that level.

Given rising inflation expectations, strong wage developments, persistently elevated crude oil prices, and progress in cost pass-through, inflation is likely to continue trending upward. The author expects the next rate hike in December 2026, followed by another in April 2027.[1]

As long as financial conditions remain supportive of the economy, the BOJ will likely be prepared to continue raising rates at a pace of approximately once every quarter. A faster pace of rate hikes would require a further materialization of upside risks to inflation or a substantial increase in imported inflationary pressures resulting from rapid yen depreciation. Conversely, if the cumulative effects of past rate hikes cause financial conditions, including bank lending and asset markets, to become clearly restrictive to economic activity, the pace of rate hikes is likely to slow.

The author continues to expect the policy rate to peak at around 2%. Governor Ueda did not indicate a specific level for the terminal rate, stating that it would become clear only ex post. He did not indicate that the current policy rate of 1.25% had reached the neutral rate. This suggests that he has not ruled out raising the policy rate above the neutral rate if upside inflation risks intensify.

There is no need to revise the terminal-rate forecast at this point. However, given the shift in the policy phase toward placing greater emphasis on addressing upside risks than before, the risks to the monetary policy path are skewed toward earlier rate hikes and a slightly higher policy rate path.

Following the September meeting, the BOJ's policy objective shifted from raising the underlying inflation rate toward 2% to stabilizing it at around 2%. Preemptive action against upside risks, efforts to gauge the neutral rate through financial conditions, and the redesign of funds-supplying frameworks in line with the normalization phase will constitute the key elements of monetary policy management going forward.

[1] The views expressed herein do not necessarily reflect the official views of Daiwa Securities.

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