

Economic Commentary (Oct BOJ MPM preview)

Focus on monetary policy conduct once underlying inflation hits 2%

- Oct meeting expected to keep rates unchanged; board member Takata may propose another rate hike
- With underlying inflation reaching 2%, policy phase will shift to “confirming stabilization”
- Growth forecast revised upward; caution remains regarding risks of higher-than-expected inflation

Kento Minami

81-3-5555-8789

kento.minami@daiwa.co.jp

Daiwa Securities Co. Ltd.



Oct meeting: Policy interest rate expected to remain unchanged

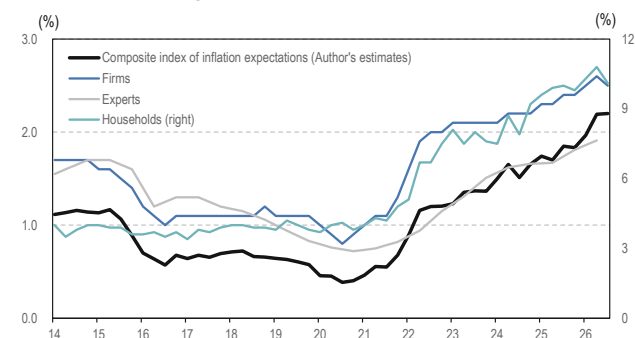
We expect that the policy interest rate will remain unchanged at the October meeting. According to reports from sources familiar with the matter, economic conditions and prices have continued to move in line with the BOJ's outlook even after the September meeting. Also, it does not appear that the Bank views the risk of inflation being higher than expected as strong enough to warrant two consecutive rate hikes (13 Oct Bloomberg report).

In fact, various surveys released in October showed that inflation expectations among households and businesses had declined. The composite index of inflation expectations growth also appears to have remained largely flat, with no higher-than-expected deviation significant enough to warrant consecutive interest rate hikes.

However, concerns about higher-than-expected inflation remain high. While the passing on of higher costs to prices is becoming more widespread at the consumer level, rising crude oil prices have recently reignited upstream inflationary pressures. Within the BOJ, there are also expectations that “the passing on of higher costs to prices will accelerate further into next year” (20 October, Reuters).

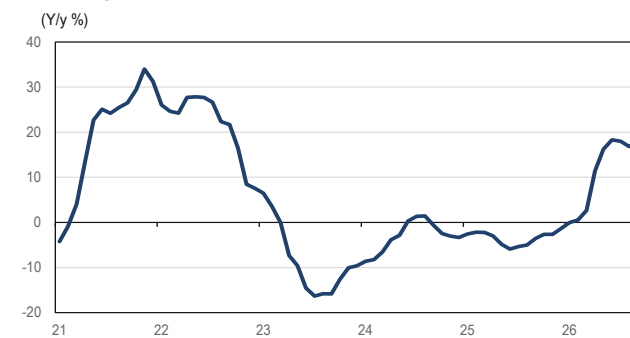
Under such conditions, it is possible that the upcoming policy board meeting will conclude that the underlying inflation rate has reached 2%. That said, signs of these shifts in the policy landscape were already evident, emerging as early as the September meeting. For that reason, at this meeting, in addition to providing guidance on policy management after underlying inflation reaches 2%, we want to assess how far the Bank is from its next rate hike. Specifically, we want to confirm the following four points: (1) Whether underlying inflation has hit 2% (as stated in the policy statement and the *Outlook Report*), (2) Whether there are dissenting votes, (3) Outlook for Economic Activity and Prices, and (4) Governor Ueda's press conference.

Chart: Inflation Expectations



source: BOJ, JCER, Bloomberg; compiled by Daiwa.

Chart: Import Prices



source: BOJ; compiled by Daiwa.

Note: Figures are calculated on a contract currency basis.

Focus point (1): Whether underlying inflation has hit 2%**Significance of reaching 2%: From approaching 2% to stabilizing around 2%**

At the October meeting, it is highly likely that the BOJ Monetary Policy Board will conclude that underlying inflation has reached 2%. That said, this probably does not mean that the Bank has achieved its price stability target. Within the conduct of monetary policy, this signifies a shift from a phase of bringing underlying inflation up to 2% to a phase of stabilizing it at around 2%.

That said, the BOJ had already hinted at these policy shifts during its September meeting. As such, a determination that underlying inflation has reached 2% would be in line with previous projections. Rather, the focus should be on how to assess whether inflation has stabilized at around 2% and how to use that assessment to guide future policy management.

Along with the transition of the above phases, the implications of policy decisions regarding higher-than-expected inflation will also change. While the Bank has thus far tolerated a rise in underlying inflation toward 2%, once underlying inflation reaches that level, it will need to place even greater emphasis on the risk of higher-than-expected inflation. If the *Outlook Report* continues to indicate the risk of higher-than-expected inflation, that would provide grounds for considering an early rate hike.

◆ Ueda press conference: (16 Oct 2026: Joint press conference with Finance Vice Minister Mimura

- (regarding decision to reach 2%) “I cannot say at this point. However, as I and others have noted, underlying inflation is already quite close to 2% and, as I stated at the previous meeting, this signifies a shift of sorts in the policy landscape. As I briefly mentioned earlier, the policy stance has shifted recently. Previously, we had tolerated price movements, meaning a gradual rise in underlying inflation toward the 2% target, since prices were rising from a low base. However, now that underlying inflation is generally close to 2%, we can no longer tolerate further increases. The situation has recently shifted such that the policy now aims to stabilize inflation at around 2%.”

Changes to October *Outlook Report* wording (projected)

That said, when determining whether underlying inflation has reached 2%, it will likely be difficult to clearly specify the underlying inflation rate. The BOJ itself has indicated that it makes a comprehensive assessment of underlying inflation based on a variety of information. For this reason, we expect that the *Outlook Report* will be revised to adopt phrasing that suggests underlying inflation has reached 2% (such as “a level broadly consistent with 2%”) rather than specifying a concrete level for underlying inflation.

Specifically, we expect that the previous phrasing “approaching 2%” will be revised and the BOJ will indicate a shift in the monetary policy focus to “stabilizing inflation at around 2%.” In particular, considering these changing circumstances, we will closely watch to see what changes, if any, will be made to the monetary policy guidelines (forward guidance).

◆ Underlying inflation rate concept and interpretation (March 2026 Bank of Japan Review)

- It is not possible to assess the underlying inflation rate based on the movement of a single indicator. Rather, a comprehensive assessment must be made after examining various economic and price-related information from multiple perspectives.

Chart: Key Changes in Wording in the *Outlook Report* (Author's Expectations)

	July <i>Outlook Report</i>	October <i>Outlook Report</i> (expected)
Baseline Scenario of the Outlook for Prices	Underlying CPI inflation is expected to increase gradually, coming to a level that is generally consistent with the price stability target between the second half of fiscal 2026 and fiscal 2027 and remaining at around that level thereafter. Given that underlying CPI inflation has been approaching 2 percent, 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 percent.	The underlying rate of increase for consumer prices is generally consistent with the "price stability target." Going forward, from the perspective of achieving the "price stability target" in a sustainable and stable manner, it will be important to monitor whether inflation becomes firmly anchored at around 2%.
Conduct of Monetary Policy	(First perspective) Underlying CPI inflation is expected to increase gradually, coming to a level that is generally consistent with the price stability target between the second half of fiscal 2026 and fiscal 2027 and remaining at around that level thereafter.	(First perspective) The underlying rate of increase in consumer prices is generally consistent with the "price stability target." Going forward, from the perspective of achieving the "price stability target" in a sustainable and stable manner, it will be important to monitor whether inflation becomes firmly anchored at around 2%.
	(Second perspective) With underlying CPI inflation approaching 2 percent, there is a risk that it will deviate upward to a level above the 2 percent price stability target, given factors such as firms' behavior shifting more toward raising wages and prices and medium- to long-term inflation expectations continuing to rise.	(Second perspective) Considering that the underlying inflation rate is generally consistent with the "price stability target" and considering factors such as increasingly aggressive wage and price-setting behavior by firms and the continued rise in medium/long-term inflation expectations, there is a risk that the underlying inflation rate could be higher-than-expected, topping the 2% "price stability target.
	(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.	(Conduct of monetary policy) Considering that the current financial conditions are accommodative and that the underlying inflation rate is generally consistent with the "price stability target," the BOJ believes that, in order to stabilize it at around 2%, it will continue to raise the policy interest rate and adjust the degree of monetary easing in response to economic, price, and financial conditions.

source: BOJ; compiled by Daiwa Securities. Expectations for the wording in the October *Outlook Report* are by Daiwa Securities.

Focus on wage hike sustainability when assessing whether 2% inflation taking hold

We believe that the sustainability of wage increases will be a key factor in assessing whether underlying inflation is stabilizing at around 2%. In fact, in her 15 October speech, policy board member Junko Koeda indicated that, when assessing the extent to which price increases have taken hold, she places importance not only on the breadth of the price increases, but also on steady wage growth.

A more detailed analysis of the basis for determining that the underlying inflation rate has reached 2% is likely to be presented in the full text of the *Outlook Report*, which will be released on the first business day following the policy board meeting. We want to confirm how wage and pricing behavior are evaluated.

Focus point (2): Whether there are dissenting votes

When assessing the distance to the next rate hike, we will also want to know whether there are any dissenting votes against the decision to keep rates unchanged. In this regard, we anticipate that policy board member Hajime Takata will propose a rate hike in response to the decision to maintain the status quo.

Takata proposed an additional rate hike at the July meeting, following the rate hike at the June meeting. He called for flexible policy responses, citing risks such as higher-than-expected inflation due to demand shocks originating overseas. Considering the current strong global demand, driven in part by growing demand for AI-related products, we believe that Takata could again propose an interest rate hike this time as well.

Meanwhile, in his past speeches, policy board member Naoki Tamura indicated his recognition that interest rates will be hiked "once every few months" to reach a neutral rate of interest of around 2%. Considering that interest rates were raised at the September meeting, it is likely that Tamura will provide strong support for keeping rates unchanged this time.

◆ Comments and awareness from Takata, Tamura

- **(Takata)** “We have entered a new phase that requires agile responses to risks of higher-than-expected inflation pressures caused by demand shocks originating overseas, as well as to shifts in global financial conditions (proposal to hike interest rates at July 2026 meeting in response to decision to maintain status quo).”
- **(Tamura)** “Our basic plan is to hike the interest rate by 0.25% every few months, with the goal of reaching a 2% neutral rate of interest (25 June 2026 financial and economic roundtable in Hyogo prefecture)

Focus point (3): Outlook for Economic Activity and Prices

The third point is the Outlook for Economic Activity and Prices presented in the BOJ's *Outlook Report*. With the global economy proving resilient, Japan's economy is also performing well overall. Considering these recent economic trends, we expect Japan's real GDP growth forecast for FY26 to be revised slightly upward.

Turning to prices, considering that the recent rise in crude oil prices, we expect the core CPI forecast for FY27 to be revised slightly upward. Meanwhile, the inflation outlook as of July appears to have been somewhat on the high side. Also, based on actual data up until now, we expect the core-core CPI forecast for FY26 to be revised downward slightly.

However, even after the downward revision, the BOJ is still expected to maintain its outlook for relatively high inflation in the second half of FY26. If we work backward to determine the future CPI growth rates needed to achieve a 2.5% increase for core CPI and a 2.4% increase for core-core CPI for FY26 and, assuming the September CPI comes in line with market expectations, the core CPI would need to rise by approximately 3.4% y/y and the core-core CPI by approximately 2.9% y/y from October 2026 through March 2027. These growth rates are considerably higher than our forecasts, suggesting that the BOJ anticipates a relatively high inflation rate in the second half of FY26 as well.

When assessing the outlook for prices in FY27, it is important to consider the treatment of the consumption tax reduction on food products. However, it is highly likely that the *Outlook Report* will not factor in that impact this time. If the consumption tax rate on food were reduced from 8% to 1%, the direct downward effect on the CPI would be approximately 1.4% for the core CPI and approximately 1.5% for the core-core CPI in FY27.

As for the balance of risks, we anticipate that the economy is generally in balance, while also assuming that there remains a significant risk that higher-than-expected inflation will persist.

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

	Real GDP		Core CPI		Core-core CPI	
	Jul 2026*	Oct 2026**	Jul 2026*	Oct 2026**	Jul 2026*	Oct 2026**
FY26	+0.6 %	+0.8 %	+2.5 %	+2.5 %	+2.5 %	+2.4 %
FY27	+0.8 %	+0.8 %	+2.4 %	+2.5 %	+2.6 %	+2.6 %
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).

BOJ Governor Ueda's press conference: Focus on assessment of whether 2% target has been met, implications for Dec meeting

At his regular press conference following the policy board meeting, we want to focus on three points: (1) rationale for determining that underlying inflation has reached 2% and the criteria for assessing whether it has taken hold, (2) any hints regarding a rate hike in December, and (3) assessment of financial conditions.

Reasons for reaching 2% underlying inflation target, criteria for whether it has taken hold

During Ueda's press conference, we want to confirm exactly what specific data and information were given the most weight in determining that the underlying inflation rate had reached 2%. Also, when assessing whether underlying inflation is stabilizing at around 2% after reaching that level, another key consideration is which indicators (such as wages and pricing behavior) will be prioritized.

Hints regarding Dec meeting

During Ueda's press conference, we want to gauge the strength of any signals ahead of the December meeting. In addition to the overall tone of the meeting, we want to pay particular attention to whether Ueda explains that decisions on interest rate hikes will be made "at every meeting," or whether he uses phrasing such as "discussed at the next meeting or later."

The former example is a way of phrasing that does not specifically refer to a particular meeting. Meanwhile, if the wording shifts to one that places greater emphasis on the next meeting, as in the latter example, the market may interpret this as a stronger signal of a rate hike in December.

◆ Comments from BOJ Governor Ueda

- "This means that **in future monetary policy board meetings, we will carefully analyze and discuss** factors that impact the economy and prices **before making any policy decisions** (July 2026 post-meeting press conference)."
- With a view to anchoring the underlying inflation rate at 2% going forward, we will review the economic and inflation outlooks, consider the associated risks, and **conduct thorough analyses at each monetary policy board meeting to determine the appropriate policy course** (September 2026 post-meeting press conference).

Assessment of financial conditions

Finally, we want to see if there have been any changes in the assessment of financial conditions. Following the rate hike at the September meeting, the policy rate has already exceeded the lower bound of the BOJ's estimated neutral rate of interest range (+1.1% to +2.5%).

Under these circumstances, once underlying inflation reaches 2%, conducting a comprehensive assessment of financial conditions (including interest rates, asset prices, forex, and bank lending), rather than just automatically raising interest rates based solely on inflation trends, will become even more urgent.

The focus of this meeting lies not so much on the assessment of whether underlying inflation has reached 2%, but rather on how the BOJ will shift the focus of its monetary policy from "approaching 2%" to "confirming that inflation has stabilized around 2%." Furthermore, based on that, we want to assess how far away the next rate hike is by considering whether there were any dissenting votes at the meeting, the wording of the *Outlook Report*, Ueda's press conference, and the assessment of financial conditions.

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