MONETARY AFFAIRS:

Preview: BoJ on Hold

While Bond and FX Stresses Are Rising

by

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Executive Summary

- **Expected Decision**: *The Bank of Japan (BoJ) is likely to keep its policy rates unchanged in January.* In the upcoming monetary policy meeting, we expect the BoJ to keep its key short-term interest rate at 0.75%. The BOJ kept its current tapering plan to cut JGB purchases by ¥400 billion per quarter, targeting ¥3 trillion monthly buying by March 2026. From fiscal 2026, *it will slow the pace*, halving reductions to reach ¥2 trillion by March 2027, in line with market feedback, fearing an impact on market and financial stability. Starting next week the BoJ will also start sales of its ETF holdings, a form of QT.
- **Policy Discussion**: *BOJ Governor Kazuo Ueda said the central bank will continue raising interest rates if growth and inflation develop in line with its forecasts, pointing to a likely sustained rise in wages and prices*. While the December hike lifted the policy rate to 0.75%, its highest level in 30 years, board members stressed that monetary conditions remain highly accommodative and well below the neutral rate. In the meanwhile, a rise in bond yields and further yen weakness creates additional challenges for the BoJ.

  Economists expect the BOJ to pause in the near term, keeping rates unchanged at the January and March meetings to assess the impact of the latest move. July is widely seen as the most likely timing for the next hike, with more than 75% of economists expecting rates to reach at least 1% by September. A rate hike may occur as early as April if the yen keeps on weakening and sterilized FX intervention doesn't stop such weakness. The median forecast for the terminal rate stands around 1.25–1.5%, keeping Japan out of step with global peers that have largely been cutting rates.

  Political factors may temper the pace of tightening. Prime Minister Sanae Takaichi, a known advocate of loose fiscal and monetary policy, has urged caution and warned against moving too quickly, particularly as the government prepares for a snap election. Still, inflation above target, ongoing wage–price momentum, and concerns over yen weakness suggest the BOJ will continue normalising policy gradually despite political headwinds; additionally more yen weakness could trigger FX intervention soon. The recent volatility in the bond market with a surge in JGBs bond yields – and its international spillovers - creates additional challenges for the BoJ. That yen weakness and rise in bond yields is partly driven by additional fiscal stimulus and the risk of its monetization by the BoJ, ie the risk of fiscal dominance. Early elections next month that would strengthen the current PM would reinforce the risk of further fiscal policy loosening. The BoJ may need to raise sooner – ie in April - to re-asset monetary dominance; but markets seem to be skeptical that the BoJ would challenge the fiscal authorities; thus the concern about debt debasement, higher long rates and weaker yen. It is not clear who will win the game of chicken between monetary and fiscal authorities. Senior US policy makers have contacted their Japanese counter-parties to address these bond and FX risks.
- **Changes to Economic Forecasts:** *Markets are watching the Jan. 22–23 outlook for signals on yen-driven inflation after recent currency weakness lifted import costs and yields.* The BOJ is likely to raise its FY growth forecast from 0.7%, reflecting PM Sanae Takaichi's ¥17.7tn fiscal package already factored into December's hike to 0.75%. While headline inflation may ease as food and utility prices cool, the BOJ is focused on underlying trends. With the yen still weak and firms passing on costs, officials see scope for further tightening if core inflation remains firm.

Key Picture: Bank of Japan Forecasts – 2024-2026 – From the October 2024 Outlook

	2025*f*			2026*f*		2027*f*	
	Latest Reading	October Report	July Report	October Report	July Report	October Report	July Report
GDP *(real growth, y-o-y)*	**1.1**	**0.7**	**0.5**	**0.7**	**0.7**	**1.0**	**1.0**
Inflation* *(%, y-o-y)*	**2.9**	**2.7**	**2.7**	**1.8**	**1.8**	**2.0**	**2.0**

Source: Bank of Japan '*Outlook for Economic Activity and Prices*' May and January 2025. *Note:* 1. Forecasts are for the fiscal year (FY) in Japan from April 1 - 31 March of the following year; 2. Latest GDP reading for Q3-2025; 3. Latest inflation reading for November 2025.

Analysis

- **EXPECTED DECISION**: *On January 23, we expect the Bank of Japan (BoJ) is keep its policy rates steady.* In the upcoming monetary policy meeting, we expect the BoJ to keep its key short-term interest rate unchanged at "around 0.75%". At the December 19 meeting, the BOJ raised its benchmark rate to 0.75%, the highest in 30 years, with some members favoring additional increases at intervals of a few months.

  In terms of *forward guidance*, the BOJ will underline that future rate moves will be guided by the impact of past hikes on lending, financing conditions and economic activity. Even though, the BoJ raised its policy rate last month, but real rates remain deeply negative as inflation has stayed above target for nearly four years. Markets are now focused on the Jan. 22–23 outlook for clues on yen-driven inflation, after recent currency weakness pushed up import costs and bond yields.

  In terms of *balance sheet policies*, the BoJ, by an 8-1 vote, agreed to gradually reduce its monthly JGB purchases to around ¥2 trillion by January–March 2027—cutting about ¥400 billion per quarter until early 2026, then ¥200 billion per quarter from April 2026 onward. The Bank retains flexibility to intervene if long-term rates rise sharply and may revise the plan at any policy meeting if needed. As of the June 2025 quarter, the Bank of Japan is estimated to purchase approximately ¥4.1 trillion in JGBs each month.

- **POLICY DISCUSSION:** *BOJ Governor Kazuo Ueda said the central bank will continue raising rates if growth and inflation evolve as forecast, citing a likely sustained rise in wages and prices.* Speaking to the banking sector, he said adjusting monetary support is key to durable growth, even as higher U.S. tariffs weighed on profits.

  The BOJ waited 11 months between its January 2025 hike and the December move, and economists expect a similar pause. In the latest Reuters poll, nearly all respondents see rates unchanged at the January and March meetings, with July the most likely timing for the next hike. Thus, with over 75% seeing rates reaching at least 1% by September from the current 0.75%. Even as the BOJ moves toward a median terminal rate of 1.5%, it remains an outlier globally, as most peers have been cutting rates in recent years.

  Three-quarters of economists now expect the policy rate to reach at least 1% by end-September, up from last month, with a growing minority seeing 1.25%. The median forecast for end-2025 remains 1.0%, though some expect further upside. Most respondents see one hike this year, while about a third expect two, and views on the risk of the BOJ falling behind inflation are broadly balanced. A rate hike could occur as early as April if the yen weakens further and sterilized FX intervention doesn't stem its slide.

  Seen as a fiscal and monetary dove, Japan's new Prime Minister Sanae Takaichi unsettled markets after taking office in October by stressing her preference for low rates and claiming influence over monetary policy. She plans to dissolve parliament and call a snap election next week, while advisers have warned against further rate hikes. Most analysts say the BOJ will avoid rushing into another move, preferring to assess the impact of December's quarter-point hike unless yen weakness fuels imported inflation; if so a policy hike could occur as early as April.

Moreover, the recent volatility in the JGB bond market with a surge in JGBs bond yields – and its international spillovers to other G7 bond markets - creates additional challenges for the BoJ. That yen weakness and rise in bond yields is partly driven by additional fiscal stimulus and the risk of its monetization by the BoJ, ie the risk of fiscal dominance. Early elections next month that would strengthen the current PM would reinforce the risk of further fiscal policy loosening. The BoJ may need to raise sooner – ie in April - to re-asset monetary dominance; but markets seem to be skeptical that the BoJ would challenge the fiscal authorities; thus the concern about debt debasement, higher long rates and weaker yen. It is not clear who will win the game of chicken between monetary and fiscal authorities. But bond and FX markets may force the hand of the BoJ to hike sooner to avoid further yen weakness and assert monetary dominance; otherwise bond yields could go even higher if inflation expectations get un-anchored.

According to December meeting minutes, several BoJ board members signaled that policy remains highly accommodative, arguing that Japan's real interest rate is still among the lowest globally and that further rate hikes are likely. The discussion showed the BOJ does not yet view policy as neutral, with members noting significant distance from the neutral rate, which the bank estimates broadly at 1%–2.5%. While acknowledging uncertainty around that level, most stressed the need for flexibility rather than targeting a specific endpoint. Economists expect another hike in about six months, with the terminal rate seen around 1.25%, though some forecasts run higher.

Members also cited sustained wage–price dynamics and reduced risks from U.S. tariffs as supporting further tightening. Yen weakness remained a concern but was less central than earlier this year. The summary suggested the government did not oppose the hike, despite caution from Prime Minister Sanae Takaichi's pro-stimulus camp, with inflation and currency pressures limiting political resistance.

- **CHANGES TO ECONOMIC FORECASTS:** *Markets are watching the Jan. 22–23 outlook for signals on yen-driven inflation, as recent currency weakness has lifted import costs and bond yields*. In its January outlook report, the BOJ is likely to raise its FY growth projection from 0.7%, and may also revise up the current-year forecast, reflecting the impact of Prime Minister Sanae Takaichi's ¥17.7tn fiscal package aimed at supporting growth and offsetting inflation pressures. Last meeting, the BOJ raised rates to 0.75% in December, factoring in the new fiscal measures, which officials believe increase the likelihood of achieving the bank's inflation outlook.

  Although headline inflation is expected to slow as food prices ease and government measures cap utility costs, BOJ officials say they will look through temporary factors and focus on underlying price trends. With the yen still weak and firms increasingly passing costs on to consumers, officials see little need to alter their medium-term inflation outlook, keeping the door open to further tightening if underlying inflation remains firm.

- **MACROECONOMIC ANALYSIS:** *Japan's Q3 GDP contraction reflected weaker capital spending, though economists see the downturn as temporary with little impact on BoJ rate plans*. Japan's economy shrank 0.6% q-o-q in Q3 2025, a deeper contraction than expected and the first since Q1 2024, following a downwardly revised 0.5% expansion in Q2. The downturn was driven by a surprise fall in business investment (-0.2%), soft consumption (+0.2%), slower government spending, and a drag from net trade as exports slumped after new US tariffs. Higher borrowing costs continued to weigh on activity. Housing investment stayed weak due to tighter regulations. Economists expect growth to resume next quarter, supported by a gradual recovery in consumption, even as pressure on corporate investment persists.

Labour market conditions remained stable, with unemployment at 2.6%, but income dynamics weakened sharply. Nominal wages rose just 0.5% YoY in November—the slowest pace in nearly four years—hit by a collapse in bonus payments, while real wages fell 2.8% amid still-elevated inflation, further squeezing household purchasing power.

Inflation eased slightly, with headline CPI slipping to 2.9% in November from 3.0%, helped by slower food price growth, while core inflation held at 3.0%—above the BoJ's target for the 44th straight month. This keeps pressure on the Bank of Japan to tighten policy, though the sharper GDP contraction and calls from the government to prioritise fiscal support complicate the case for near-term rate hikes.

- **MARKET IMPLICATIONS:** *Market volatility has eased as Japanese bond yields pull back from multi-decade highs, but ongoing concerns about Japan's fiscal position continue to weigh on the yen.* Japan's bond market is under unprecedented strain following a historic shift away from decades of near-zero interest rates. Ten-year government bond yields have risen to around 2.29%—their highest level since 1999—unsettling investors long used to Japan as a pillar of global financial stability. Since the last meeting on December 19, the 10-year JGB yield increased by 27 bps to 2.29% (+22 y-t-d). 2Y JGB rose by 29 bps 1.23% (+6 y-t-d). *The pair JPY/USD stabilizes above 158 due to US tariff concerns.* USD/JPY increased by 0.3% to around 158 since the last meeting (+1.0% y-t-d). *The Nikkei 225 has retreated from its record high,* drifting back toward the November and 6 January peaks at 52,637–52,524 amid broader risk-off sentiment. Tokyo stocks fell on Wednesday, with the Nikkei extending losses for a fifth straight session as concerns grew over escalating US–Europe trade tensions linked to Greenland. Since the last meeting in December, Nikkei 225 rose by 6.6% to 52,774.64 (+3.1% y-t-d).

- **APPENDIX (Macro Background):** *The economy contracted for the first time since Q1 2024,* after a downward revision to 0.5% growth in Q2, as business spending fell for the first time in three quarters. According to the final estimate, in Q3, the GDP contracted by 0.6% q-o-q (*c:* -0.5%; *p:* 0.5%) in the Q3. Government spending also eased to 0.2% (*p:* 0.3%) and private consumption stayed subdued, raising by 0.2% (*p:* 0.3%). Net trade was an additional drag (-0.2ppts), as exports fell more sharply (-1.2% vs 2.3% in Q2) than imports (-0.1% vs 1.3%) following Washington's imposition of a 15% baseline tariff on most Japanese goods in September. Business investment fell for the first time in three quarters (*a:* -0.2%; *p:* 1.3% in Q2). In Q3, GDP expanded 1.1% y-o-y (*p:* 2.0%).

  Despite hitting Composite PMI its lowest level since May, it still marked a tenth straight month of private-sector expansion. Momentum eased as services slowed, while manufacturing broadly stabilized. In December, Jibun Bank composite PMI fell to 51.1 (*c:* 51.5; *p:* 52.0). Services PMI declined to 51.6 (*c*: 52.5; *p:* 53.2). Manufacturing increased to 50 (*c:* 49.7; *p:* 48.7).

  Japan's unemployment rate remains at the highest reading since July 2024. The unemployment rate stood at 2.6% in November (*c*: 2.6%; *p*: 2.6%). The number of unemployed declined by 40K to 1.81 ml. Meanwhile, Japan's nominal wages grew just by 0.5% y-o-y (*c:* 2.3%; *p:* 2.5%) in November. However, wages continued to trail inflation for a tenth consecutive month, as price increases again outpaced pay gains.

  Japan's annual inflation eased in November, down from October's three-month high of 3.0%. In November, *CPI inflation* edged down to 2.9% y-o-y (*p:* 3.0%). Food inflation hit its lowest in a year, rising by 6.1% (*p:* 6.4%). Core inflation stood at 3.0% y-o-y in November (*c*: 3.0%; *p:* 3.0%).

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