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Review: BoJ Remains on Hold, But The Stagflationary Shock Leaves a Hiking Bias

by

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Executive Summary

- **Decision Made**: *The Bank of Japan (BoJ) maintained its policy rates in April*. The BoJ board voted to keep its short-term policy rate unchanged at 0.75% with three dissenters. The Bank signals gradual rate hikes as inflation nears target and real rates remain low, with timing guided by economic and geopolitical risks.
- **Policy Discussion**: *Governor Ueda said policymakers paused to assess what they still view as a temporary supply shock, but signalled readiness to tighten if inflation rises and growth holds*. The Bank of Japan voted 6-3 to hold rates, with dissenters pushing for a hike to 1.0% on the view that inflation risks are already skewed to the upside.

  The Bank signalled a clear tightening bias: rate hikes could follow if inflation meets or exceeds forecasts or confidence in the outlook strengthens, even with modest growth slowing. Ueda added that if underlying inflation overshoots, rates may need to rise above neutral, implying more forceful tightening despite higher volatility.

  At the same time, heightened uncertainty—particularly from Middle East tensions—has weakened confidence in the outlook, with downside risks to growth and upside risks to inflation. The Bank will look through temporary shocks but act if second-round effects push underlying inflation higher, maintaining a cautious but tightening-leaning stance.
- **Changes to Economic Forecasts:** *The BOJ has sharply raised its inflation forecasts and warned of overshoot risks, pointing to a likely path of rate hikes.* The economy is recovering moderately but remains uneven: exports and industrial output are flat, while consumption is resilient despite price pressures. Investment is gradually rising on solid business sentiment, labor markets are tight, and financial conditions remain accommodative, even as inflation has eased to around 1.5-2%.

  Higher oil prices are now passing through more broadly into goods and services, prompting upward revisions to inflation and downward revisions to growth. Middle East tensions add a stagflationary risk mix—weakening growth via profits, incomes, and supply chains, while pushing prices higher through energy and broader cost pressures.

Key Picture: Bank of Japan Forecasts – 2025-2027 – From the January 2026 Outlook

		2026*f*		2027*f*		2028*f*
	Latest Reading	April Report	January Report	April Report	January Report	April Report
GDP (*real growth, y-o-y*)	0.1	0.5	1.0	0.9	1.0	0.8
Inflation* (*%, y-o-y*)	1.5	2.8	1.8	2.3	2.0	2.0

Source: Bank of Japan '*Outlook for Economic Activity and Prices' April and* January *2026. 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 Q4 -2025; 3. Latest inflation reading for March 2026.

Analysis

- **DECISION MADE**: *On April 28, the Bank of Japan (BoJ) kept its policy rates unchanged.* The BoJ kept its key short-term interest rate at 0.75% with three dissenters, signalling rising concern over Middle East–driven inflation pressures. Three BOJ board members (Makagawa, Takata, and Tamura) dissented, calling for a hike to 1.0%.

  In terms of *forward guidance*, with inflation nearing target and real rates still low, the Bank signals further gradual rate hikes, carefully calibrating timing and pace in response to economic conditions and geopolitical risks. The Bank of Japan assesses policy through a baseline outlook and key risks. Inflation is projected at 2.5-3.0% in fiscal 2026, driven by higher oil prices and wage pass-through, before easing to around 2% by 2028. Tight labor markets should sustain a gradual wage-price cycle, bringing underlying inflation in line with the 2% target from late 2026 onward.

  In terms of *balance sheet policies*, the BoJ 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:** *Governor Ueda said policymakers paused to assess the fallout from what they still see as a temporary supply shock, but signalled readiness to tighten if inflation risks intensify and growth remains resilient.* The board voted 6-3 to maintain its current policy stance. Governor Kazuo Ueda and five members backed the decision, while three dissented. The dissenters argued that inflation risks are already tilted to the upside: Junko Nakagawa pointed to persistent uncertainty and accommodative conditions, Hajime Takata said the price target is largely achieved with rising second-round effects, and Naoki Tamura called for moving rates closer to neutral. They proposed lifting the policy rate to around 1.0%, but the motion was rejected by majority vote.

  The Bank of Japan signalled it stands ready to raise rates if inflation risks intensify and growth remains resilient, with decisions guided by how shocks—such as disruptions in the Strait of Hormuz—feed through to the economy and prices. Strengthening confidence in its outlook, or inflation meeting or exceeding forecasts, could justify tightening even amid modest growth slowing. Governor Ueda added that if underlying inflation overshoots, rates may need to rise above neutral, implying more forceful tightening despite potential increases in economic volatility.

  The BOJ says heightened uncertainty has reduced confidence in its outlook, with downside risks to growth and upside risks to inflation, especially in fiscal 2026. Given unclear duration and impact, policymakers will take more time to assess how the conflict shapes economic activity and prices before adjusting their stance. The Bank will look through temporary, supply-driven inflation, but stands ready to raise rates if second-round effects lift underlying inflation.

  The Bank's outlook stresses upside inflation risks, while Ueda's remarks balanced these against downside growth risks. Despite uncertainty over the yen, the broader tightening path remains intact.

- **CHANGES TO FORECASTS:** *The BOJ sharply raised its inflation forecasts and warned of overshoot risks, signalling a strong likelihood of rate hikes in the coming months.* Japan's economy is recovering moderately, with some softness linked to Middle East tensions. Exports and industrial output are flat, while firms remain profitable despite tariff pressures on manufacturing. Business sentiment is generally positive, supporting a gradual rise in investment. Consumption is resilient on improving incomes but weighed by higher prices; housing is declining and public investment is flat. Labor markets remain tight and financial conditions accommodative. Inflation has eased to around 1.5-2% after exceeding 2%, with expectations rising moderately.

Rising oil prices are now more easily feeding through into a broad range of goods and services, reflecting a stronger pass-through than in the past. Against this backdrop, the board has sharply upgraded its inflation outlook, projecting core CPI at 2.8% for fiscal 2026 (up from 1.9% in January), 2.3% for 2027 (from 2.0%), and 2.0% for 2028. At the same time, growth expectations have been revised down, with real GDP seen at 0.5% in 2026 (from 1.0%), 0.7% in 2027 (from 0.8%), and 0.8% in 2028.

Middle East tensions pose two key risks. First, persistently high oil prices could worsen Japan's terms of trade, eroding corporate profits and real incomes, slowing growth, and weakening underlying inflation. However, inflation risks remain tilted to the upside, as higher energy costs may pass more broadly into goods and services prices, supported by stronger wage-price dynamics and rising inflation expectations. Food prices could also rise further if fertilizer supply disruptions persist. Second, prolonged disruptions to supply chains could hit production, particularly in sectors reliant on Middle East inputs, leading to slower growth. While weaker activity could dampen inflation, supply constraints may instead push prices higher, reinforcing upside inflation risks. Conversely, a rapid easing of tensions and lower oil prices would reduce pressure on profits and incomes, supporting growth.

- **OUR TAKE:** *The BoJ may increase rates in coming months, if the economy holds up well.* The pre-condition for the BoJ to increase rates is that the economy holds up well: if inflation rises but the economy is weak, it would be harder for the Bank to tighten its policy stance. If the situation remains as is, the BoJ will likely rise rates in coming months, possibly as early as June.
- **MARKET IMPLICATIONS:** *Ueda said the pause allows time to assess a temporary supply shock, but signalled readiness to hike if inflation rises and growth holds; markets lifted the yen and priced in a possible June move.* Ueda struck a less hawkish tone than the statement, prompting the yen to trim early gains despite an initially hawkish outlook and three dissenting votes. Still, he signalled a credible path to further tightening, balancing that message with the need to justify holding rates at this meeting. The decision comes amid rising bond yields, with the 10-year JGB recently hitting its highest since 1997. After the announcement, yields held steady around 2.47%. *The yen slumps despite hawkish tone.* The BOJ decision saw USD/JPY pull back from around 159.50 to near 159.00. Currently USD/JPY trades around 156.6. *Japanese stocks closed lower.* The Nikkei 225 index closed down 1.02% at 59,917.46 points.