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Review: BoJ Keeps Rates Unchanged, But Signals Further Tightening Ahead

by

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Executive Summary

- **Decision Made**: *The Bank of Japan (BoJ) kept its policy rates in July*. The BoJ board voted to keep its short-term policy rate unchanged at 1.0%. The decision passed 8-1, with board member Hajime Takata dissented, proposing a rate hike to 1.25% amid rising upside inflation risks, but was outvoted. The BOJ also turned more hawkish, warning for the first time that underlying inflation could exceed its 2% target and reiterating that further rate hikes will depend on incoming economic and financial data.

  On the balance sheet, the BoJ announced it will pause bond tapering from April 2027, maintaining monthly purchases of around ¥2 trillion in government bonds. While annual reviews of the tapering plan will be discontinued, the Bank retained flexibility to adjust purchases if conditions require.
- **Policy Discussion**: *The BOJ maintained its tightening bias despite Japan's latest yen-buying intervention, adopting a more hawkish tone than in its April Outlook Report.* For the first time, it warned that underlying inflation could exceed its 2% target, with Governor Kazuo Ueda highlighting upside risks from AI-related demand, yen weakness, and developments in the Middle East.

  The meeting also revealed growing divisions within the Policy Board. Board member Hajime Takata again dissented in favour of raising the policy rate to 1.25%, reinforcing expectations that further tightening remains a question of timing rather than direction.

  The hawkish guidance pushed two-year JGB yields higher, while markets continued to price around 20bp of additional tightening by October. Ueda's remarks increased expectations of a September rate hike, while some analysts forecast that the policy rate will reach 2% by the end of next year.
- **Changes to Economic Forecasts:** *The BOJ left its growth forecasts broadly unchanged but adopted a more hawkish inflation outlook*, highlighting strong AI-related demand, yen weakness, and higher energy prices as key upside risks. It expects headline inflation to exceed 2% in the second half of FY2026 before easing, while underlying inflation is projected to stabilise sustainably around the 2% target. The Bank said Middle East-related risks have eased but warned that higher energy costs could still feed through to prices, reinforcing the case for further policy tightening.

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

		2026*f*		**2027*f***		**2028*f***	
	Latest Reading	**July Report**	**April Report**	**July Report**	**April Report**	**July Report**	**April Report**
GDP *(real growth, y-o-y)*	**0.6**	**0.6**	**0.5**	**0.8**	**0.7**	**0.8**	**0.8**
Inflation* *(%, y-o-y)*	**1.7**	**2.5**	**2.8**	**2.4**	**2.3**	**2.0**	**2.0**

Source: Bank of Japan '*Outlook for Economic Activity and Prices' April and July 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 Q1 -2026; 3. Latest inflation reading for June 2026

Analysis

- **DECISION MADE**: *On July 30, the Bank of Japan (BoJ) kept its policy rates unchanged.* The BoJ kept its key short-term interest rate to 1.0% with one dissenter, Takata Jajime. He dissented arguing that the Bank should adopt a nimble approach as the economy enters a new phase marked by upside inflation risks from external demand shocks and changing global financial conditions. Takata proposed keeping the uncollateralized overnight call rate at around 1.25%, but the proposal was rejected by a majority vote.

  In terms of *forward guidance*, the BOJ warned for the first time that underlying inflation could exceed its 2% target, reinforcing expectations of further rate hikes. While noting that financial conditions remain accommodative and continue to support economic activity, the Bank assessed growth risks as broadly balanced but inflation risks as skewed to the upside, driven by stronger wage-price dynamics, AI-related demand, yen weakness, and Middle East-related energy prices. It reiterated that further policy tightening will be guided by incoming economic, inflation, and financial data.

  In terms of *balance sheet policies*, the BoJ also announced that it will pause its bond tapering programme from April 2027, maintaining monthly purchases of around ¥2 trillion ($12.5 billion) in Japanese government bonds. The Bank will discontinue its annual reviews of the tapering plan, while retaining the flexibility to adjust the pace of bond purchases at future policy meetings if conditions warrant.

- **POLICY DISCUSSION:** *The BOJ remains on course for further policy tightening amid broadening inflationary pressures, while Japan's latest yen-buying intervention underscored growing concerns over persistent currency weakness.* The BOJ adopted a more hawkish tone than in its April Outlook Report, warning for the first time that underlying inflation could exceed its 2% target rather than merely approach it. Governor Kazuo Ueda said the Bank would place greater emphasis on upside inflation risks in future policy deliberations, reiterating that further rate hikes remain likely if the economy and inflation evolve as expected. He also noted that yen weakness is having a greater impact on inflation than in the past, with AI-related demand, exchange-rate movements, and developments in the Middle East identified as key factors shaping the policy outlook.

  The meeting also highlighted growing differences within the Policy Board. Board member Hajime Takata again dissented in favour of raising the policy rate to 1.25%, underscoring the increasingly hawkish debate over the pace of policy normalisation. Although the BOJ maintained its gradual approach, the dissent reinforced expectations that further tightening remains a matter of timing rather than direction.

  The policy statement pushed two-year Japanese government bond yields higher, while markets continued to price around 20bp of additional tightening by October. Ueda's remark that the BOJ would hold "firm discussions" from its next meeting strengthened expectations that a 25bp rate hike could come as early as September, although the yen reacted only modestly. Some analysts maintained their above-consensus forecast that the policy rate will reach 2% by the end of next year.

- **CHANGES TO ECONOMIC FORECASTS:** *The BOJ also highlighted inflationary pressures from strong global AI demand and said risks from the Middle East conflict had eased, underscoring its focus on upside inflation risks that could warrant further rate hikes.* The BOJ left its real GDP forecasts broadly unchanged, expecting moderate growth in FY2026 before a gradual pickup in FY2027 as the drag from higher oil prices fades and the wage-driven income-to-spending cycle strengthens. While higher energy costs stemming from the Middle East conflict are expected to weigh on corporate profits and household purchasing power in the near term, the Bank believes growth will continue to be supported by accommodative financial conditions, government energy subsidies, robust wage growth, and strong AI-related investment and external demand.

  The key change was in the inflation outlook. The BOJ now expects headline CPI to rise well above 2% from the second half of FY2026, driven by higher energy prices, yen depreciation, and stronger AI-related demand, before easing back toward target as energy effects fade. Although the FY2026 headline CPI forecast was revised slightly lower due to temporary government energy subsidies, the Bank maintained its core inflation projections and expects underlying inflation to converge sustainably to around 2% between late FY2026 and FY2027, supported by persistent labour shortages, stronger wage-price dynamics, and rising inflation expectations.

The risks from the Middle East have eased since the previous Outlook Report as oil prices have moderated and supply chain disruption risks have declined. However, it warned that higher energy costs could still feed through to consumer prices and keep upside inflation risks elevated. The Bank also placed greater emphasis on AI-related demand and yen depreciation as key upside risks to inflation, while noting that the timing and scale of AI-related investment remain a source of uncertainty for growth and financial markets.

- **OUR TAKE:** *New policy tightening is coming.* Economic information over the next few weeks will determine whether the BoJ will be in the position of increasing rates again in September. This seems to be the direction of travel so far, and this is why we expect another 25bps increase in the policy rate at that juncture, in our baseline scenario. But in a risk scenario, the BoJ may opt to pause for longer.
- **MARKET IMPLICATIONS:** *While policymakers highlighted upside inflation risks stemming from Middle East-related energy prices, the yen's sharp rebound following suspected government intervention eased pressure on the BOJ to tighten policy more aggressively.* Japan's 10-year government bond yield slipped below 2.8% after the BoJ left its policy rate unchanged at 1%, as expected, maintaining borrowing costs at their highest level since 1995 following June's 25bp rate hike. Earlier this month, elevated energy prices, fiscal concerns, and wide interest rate differentials had pushed the yen to a 40-year low and the 10-year JGB yield to a 30-year high. *The BOJ's decision initially pushed the yen lower,* as markets unwound some of the gains following Japan's suspected FX intervention. The yen's rebound also weighed on the US dollar, lifting the euro to a one-month high of $1.1509. At the time of the writing, USD/JPY trades around 160. *Asian stocks surged as AI shares rebounded, the BOJ held rates steady.* Asian equities rebounded sharply, with South Korea's KOSPI surging 17%, Japan's Nikkei gaining nearly 4%, and the MSCI Asia-Pacific ex-Japan index rising 6%.