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MONETARY AFFAIRS:

Review: BoJ Raise Rates and Pauses Balance Sheet Tapering

by

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Executive Summary

- **Decision Made**: *The Bank of Japan (BoJ) raised its policy rates in September*. The BoJ raised its key policy rate to a 31-year high of 1.25%. Board members Toichiro Asada and Ayano Sato dissented, arguing that sub-2% inflation and limited acceleration in economic activity and prices did not justify a hike at this stage.

  In terms of *forward guidance*, the BoJ highlighted upside inflation risks as firms increasingly raise wages and prices and longer-term inflation expectations rise. The Bank expects to continue raising rates as underlying inflation approaches 2%, with the timing and pace dependent on economic, inflation and financial conditions.

  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's 25bp hike to 1.25% marked its first increase since June and an acceleration in normalization, with just three months between hikes compared with six months previously.* Persistent inflation and wage pressures supported further tightening, while accommodative financial conditions allow the BoJ to raise rates while still supporting economic activity.

  However, the 7–2 vote highlighted divisions within the Policy Board. Toichiro Asada sought stronger evidence of wage-supported, demand-driven inflation with core inflation below 2%, while Ayano Sato stressed the need to distinguish temporary cost pressures from durable inflation and balance inflation risks against downside risks to growth.

  Governor Kazuo Ueda signaled that the policy focus has shifted from lifting underlying inflation toward 2% to preventing an overshoot. While further hikes remain likely if the outlook evolves as expected, Ueda emphasized there is no preset pace and acknowledged uncertainty around the neutral and terminal rates.

Key Picture: Bank of Japan Forecasts – 2026-2028 – From the July 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)*	**0.7**	**0.6**	**0.5**	**0.8**	**0.7**	**0.8**	**0.8**
Inflation* *(%, y-o-y)*	**1.9**	**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 Q2 -2026; 3. Latest inflation reading for August 2026

Analysis

- **DECISION MADE**: *On September 18, the Bank of Japan (BoJ) raises interest rates to 31-year high.* The BoJ raised its key short-term interest rate to 1.25% with board members Toichiro Asada and Ayano Sato dissenting from the hike. Asada and Sato dissented, arguing that sub-2% inflation and limited acceleration in economic activity and prices did not justify raising rates at this stage.

  In terms of *forward guidance*, the BOJ warned that underlying inflation risks remain tilted to the upside, as firms increasingly raise wages and prices and longer-term inflation expectations continue to rise. Looking ahead, the BoJ expects to continue raising rates as underlying inflation approaches 2%, while adjusting the timing and pace according to economic, inflation and financial conditions. Policy will remain data-dependent, with particular attention to Middle East developments, AI-related demand and exchange rates. The Bank will focus on stabilizing underlying inflation around its 2% target while limiting the risk of an inflation overshoot.

  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's 25bp hike to 1.25% marked its first increase since June and an acceleration in the normalization cycle, with just three months between hikes compared with six months previously.* The move brought rates closer to levels considered neutral and continued Japan's exit from decades of ultra-loose policy. Persistent inflation and wage pressures, including structural wage growth from a shrinking labor force, supported further tightening. Financial conditions nevertheless remain accommodative, with low real rates, robust credit demand and favorable corporate financing conditions, allowing the BoJ to raise rates while maintaining support for economic activity.

  However, the 7-2 vote highlighted growing differences within the Policy Board. Recent Takaichi appointees Toichiro Asada and Ayano Sato opposed the hike, with Asada seeking stronger evidence of wage-supported, demand-driven inflation while core inflation remains below 2%. Sato emphasized the need to distinguish temporary cost pressures from durable demand-led inflation and to balance upside inflation risks against downside risks to growth.

  At his press conference, Governor Kazuo Ueda signaled a shift in the BoJ's policy focus from lifting underlying inflation toward 2% to preventing an overshoot as inflation approaches the target. While further tightening remains likely if the outlook evolves as expected, Ueda stressed that there is no preset pace for rate increases and that decisions will be made meeting by meeting. He also acknowledged considerable uncertainty around the neutral and terminal rates, suggesting these will become clearer as normalization progresses.

  External developments could also influence the pace of tightening. The Fed's latest rate hike risks widening the USJapan rate differential, potentially adding to yen depreciation and import-driven inflation. This leaves the BoJ balancing domestic growth risks against rising inflationary pressures and currency weakness as it determines the timing of further rate increases.

- **ECONOMIC ASSESSMENT:** *Japan's economy has continued to recover moderately despite some weakness from the Middle East conflict.* Rising global AI-related demand has supported exports and industrial production, while corporate profits remain high and business investment continues to increase despite higher construction costs. Private consumption has remained resilient amid improving employment and incomes, although household sentiment is weak, while housing investment continues to decline. Labor market conditions remain tight and financial conditions accommodative.

  Growth is expected to continue at a moderate but slower pace in the near term, as higher crude oil prices weigh on activity. However, government support, accommodative financial conditions and stronger AI-related demand should provide support, with growth expected to strengthen as the oil shock fades and the income-spending cycle improves.

Inflation has recently risen to 1.5–2.0%, reflecting higher import costs and continued pass-through of wage increases. CPI inflation is expected to accelerate clearly above 2% from H2 FY2026, driven by higher energy and goods prices, semiconductor costs and yen depreciation, before easing toward 2% later in the projection period. Underlying inflation should gradually converge with the BoJ's 2% target as wage-price dynamics strengthen and inflation expectations rise. Key risks remain developments in the Middle East, global AI demand and exchange rates.

- **OUR TAKE:** *BoJ to continue its gradual tightening process*. We expect the BoJ to continue its gradual pace of tightening, with further increases likely to take place in January 2027 rather than in 2026, but the situation may evolve differently from this baseline.
- **MARKET IMPLICATIONS:** *Despite the faster pace of tightening, the yen weakened, 10-year JGB yields fell and the Nikkei 225 advanced.* The decision came amid rising inflationary pressures and persistent yen weakness, with the BoJ warning that underlying inflation could overshoot its 2% target. The 10-year JGB yield fell roughly 5bp to 2.95%. 2-year JGB yield also fell by 4 bps to 1.82%. *Dovish hike sparks yen weakness.* The yen weakened following the BoJ's dovish guidance, falling past ¥157 per dollar. *Asian Japanese equities rose following the BoJ's rate hike, supported by lower oil prices and a tech-led rebound on Wall Street*. The Nikkei 225 gained 1.7% to 65,228, while the TOPIX rose 0.2% to 4,102.51. Broader Asian equities also advanced, with the MSCI Asia Pacific index up around 0.5%.