

BOJ avoids surprise, but pressure mounts on weak yen and inflation risks

Probability of a rate hike before year-end remains substantial

By Naomi Fink, Chief Global Strategist

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The Bank of Japan (BOJ) opted to maintain its current policy stance on 30 October, keeping its benchmark interest rate unchanged at 0.50% as widely expected. Expectations had shifted following the election of Sanae Takaichi as Prime Minister. The central bank, which is insistent that it remains independent in its policy making, appears to have refrained from upsetting the apple cart this time.

As in July, there were two dissenters within the nine-person board. This was the first BOJ policy meeting since Prime Minister Takaichi took office, and she had done little so far to dispel the assumption that her administration would espouse similarly loose monetary policy conditions as her mentor, former prime minister Shinzo Abe, despite the dissimilar macroeconomic backdrops of their administrations.

By holding steady, the BOJ may have avoided surprising markets this time. Yet the decision to stand pat underscores a growing tension. The yen's persistent weakness against the dollar, with dollar/yen trading near historically elevated levels, may challenge the BOJ's inflation-fighting resolve. The downward pressure on the yen serves as a reminder that the BOJ may be on borrowed time.

While central banks typically avoid reacting to short-term market fluctuations, the current depreciation of the yen poses a policy risk. If sustained, it could amplify imported inflation through higher costs for energy and raw materials—an outcome that would complicate the BOJ's efforts to stabilise prices without inhibiting growth. The board remains divided, with a vocal minority advocating for a more prompt withdrawal of stimulus. The majority of the board, meanwhile, continues to prioritise delaying the withdrawal amid global uncertainty.

But the BOJ is running out of material to justify its reluctance to withdraw stimulus. Despite a modest growth upgrade, its quarterly inflation outlook remains little changed from July. Furthermore, pressure will grow if prices run counter to expectations by not subsiding towards the 2% inflation target as 2026 approaches.

Meanwhile, risk asset markets have posted substantial rallies and the US economy has proven resilient since the prior outlook, contrary to the BOJ's cautious stance in July amid fears of economic retrenchment. At the same time, although the Federal Reserve (Fed) met expectations by cutting rates in October and signalled an imminent pause in the reduction of its balance sheet ("quantitative tightening"), Fed Chair Jerome Powell was reluctant to commit to additional near-term easing. Against this backdrop, the BOJ offered insufficient reassurance over its inflation-fighting resolve to prevent the yen "carry trade" from intensifying.

Looking ahead, we feel that the probability of a rate hike before year-end remains substantial. Market participants will pay close attention to signals from BOJ board members that conditions for continued rate normalisation are falling into place. Further yen weakness will only raise the stakes for the BOJ to take action on its insistence that it has not fallen “behind the curve” in fighting inflation.

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