


# External shocks complicate Fed and BOJ policy paths

## Re-emerging inflation risks seen testing central bank patience

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### A higher bar for easing for the Fed

As expected, the Federal Open Market Committee (FOMC) voted by an 11-1 majority to keep its target for the federal funds rate unchanged at 3.50–3.75% at its March meeting. The Summary of Economic Projections (SEP) continued to point to one 25 basis point (bp) rate cut in 2026 and another in 2027. However, the combined signal from the statement, the SEP and Federal Reserve (Fed) Chair Jerome Powell's comments at the post-meeting press conference amounted to a hold with a hawkish bias.

The policy statement contained only brief mention of the prospective economic impact from a broader supply shock, by explicitly referring to the "uncertain" implications of "developments in the Middle East". This addition is significant despite its brevity. It introduces some probability of a structural shift in the current inflation and interest rate regime even though the policy "dot plot" remained unchanged.

At the same time, the Fed's reaction-function language—such as the mention of the "extent and timing of additional adjustments" and the stated intent to "carefully assess incoming data, evolving outlook, [and] balance of risks"—remained superficially unchanged. Again, although the reaction-function language appears superficially unchanged, the introduction of the new input is significant because, all else equal, its impact is likely inflationary.

The SEP was also in tension with the statement. The statement described labour market momentum in softer language. However, there were significant upgrades within the SEP—not only to each annual growth projection but also longer-run growth forecasts to 2.0% from 1.8% in December. If maintained, this may imply higher equilibrium interest rates, a higher term premium or an inflation risk premium. Projections for 2026 and 2027 core and headline PCE were also upgraded, although longer-run projections still converge to the 2% target.

That upgrades to both inflation and growth were not accompanied by an upgrade to the policy outlook was a point of focus at Powell's press conference. This is because the growth and inflation outlook in the SEP is in tension with the policy path projection. The upgrades signal that there may now be a higher bar to clear for the Fed to deliver interest rate cuts, particularly if the oil shock impact proves persistent.

Partly for this reason, the press conference may also have been interpreted as more hawkish than the Fed's statement. Powell emphasised a "wait-and-see" approach, indicating increased policy conditionality that now includes uncertainty surrounding the energy supply shock with inflation still above target. Recent disinflationary data may have less influence on future policy due to the introduction of the oil shock—though the Fed remains in wait-and-see mode for now. In the press conference, progress with inflation was framed as a necessary condition for further easing rather than an expectation, which is important.

The asymmetry in language—with inflation described in terms of active constraint and growth discussed more passively—may indicate that a reaction function shift may be under way, one in which inflation expectations take precedence in an environment of high uncertainty.

Fed fund futures subsequently pared back expectations of near-term cuts and the dollar strengthened versus major peers, possibly anticipating relatively higher real rates or an inflation risk premium relative to other markets. Equities declined as markets reassessed the probability of a near-term "Fed put". Taken together, these market reactions suggest that investors interpreted the full set of FOMC policy signals as hawkish.

## BOJ holds steady as inflation risks tilt upward

As with the Fed, the Bank of Japan (BOJ) left policy unchanged at its March meeting, maintaining the overnight call rate at 75 bps. Like the Fed, the BOJ included an explicit geopolitical risk reference into its March statement, noting that "risks to the outlook include the future course of the situation in the Middle East". While both central banks stood pat, the tone of the BOJ's statement may be interpreted as more hawkish than that of the Fed. While the FOMC saw a lone dissenter in favour of a cut, BOJ board member Hajime Takata, a known hawk, dissented in support of a 25 bp rate hike to 1%.

The BOJ's inflation risk signalling was also much stronger and more specific relative to the Fed's. The BOJ statement specifically flagged expectations for "upward pressure" on CPI due to "the recent rise in crude oil prices", an exogenous cost-push factor. This represents a meaningful extension of the inflation narrative outlined in the BOJ's January Outlook, which focused on reinforcing positive wage-price dynamics.

While the BOJ reiterated its expectation from its January Outlook that CPI is expected to be "at a level… generally consistent with the price stability target" at the end of its forecast period, it cautioned that "attention should also be paid to the impact of the rise in crude oil prices on the outlook for underlying CPI inflation". The BOJ also noted more explicitly that inflation expectations are rising—albeit "moderately".

As with the Fed, the BOJ left its core reaction-function language unchanged. However, unlike the Fed, the BOJ continued to signal tightening "if the outlook… [is] realized".

An analytical interpretation of the statement suggests that the BOJ's policy stance has tightened due to inputs rather than through a shift in its guidance. We have previously highlighted the risk of a heightened terms-of-trade shock for Japan due to imported inflation, and the risk of the BOJ falling behind the curve in the absence of policy adjustment. The March statement is directionally consistent with these risks, even as it stops short of signalling a faster pace of rate hikes.

In the post-meeting press conference, BOJ Governor Kazuo Ueda brought into the policy narrative both the risk of a **terms-of-trade shock** and a **weak yen potentially amplifying the impact of imported inflation**—two themes that we highlighted as externally driven vulnerabilities for Japanese real growth. Both are identified within the BOJ's risk assessment, and the acknowledgement of these factors may enhance the central bank's inflation-fighting credibility among market participants. This was also the context for Ueda's mention of "slightly more board members noting upside risks for prices" at the press conference.

Moreover, Ueda signalled that the BOJ is re-constructing its mix of underlying inflation factors, which already look to exclude volatile items like fresh food and energy (which have been channels for short-term inflation of late) to also adjust for items artificially suppressed by government fiscal subsidies such as utilities and childcare. All else equal, such new measures could potentially help the BOJ to navigate through short-term *dis*inflationary measures and justify a faster pace of rate hikes.

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