

BOJ Policy Rate Hits Highest Since 1995 but Real Rates Remain Negative



Summary:

- The BOJ raised its policy rate by 25 basis points to 1.0% in response to inflation risks from higher oil prices, bringing the benchmark to its highest level since 1995.
- While the BOJ signalled a willingness to tighten further, the exact trajectory of future rate hikes remains uncertain.
- In addition, the BOJ decided to pause the tapering of its JGB purchases, committing to buy JPY 2 trillion per month from April 2027 onward.

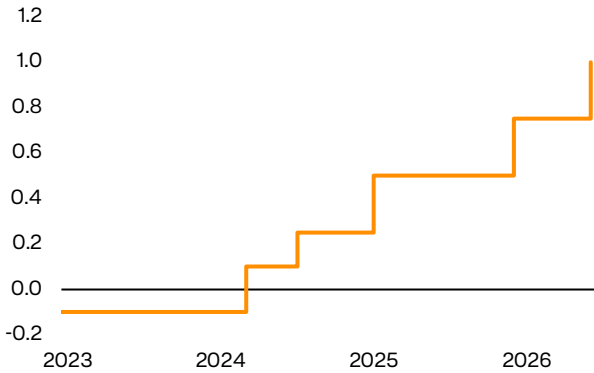
The Bank of Japan (BOJ) delivered a widely expected rate hike to 1.0% amid mounting inflation risks stemming from elevated oil prices. At its June monetary policy meeting, the BOJ raised the uncollateralised overnight call rate from 0.75% to 1.0%, bringing interest rates to their highest level since 1995. The 7-1 decision saw a dissent from Toichiro Asada, a dovish board member newly appointed by Prime Minister Sanae Takaichi, who argued that the downside risks to production and employment outweigh inflationary pressures. Following the meeting, Deputy Governor Shinichi Uchida led the press conference on behalf of Governor Kazuo Ueda, who was hospitalised.

The BOJ assessed that the economy is recovering moderately, while highlighting the risk of upward deviations in inflation. During the press conference, Deputy Governor Uchida noted that downside risks tied to the Middle East conflict have subsided significantly compared to the previous meeting, allowing for a steady economic recovery. On the price front, the BOJ expects the pass-through of higher crude oil prices into business-to-business transactions to materialise relatively quickly, potentially fuelling longer-term inflation expectations. Against this backdrop, the BOJ identified a "risk of underlying inflation deviating upward" beyond its 2% price stability target.

Market Commentary

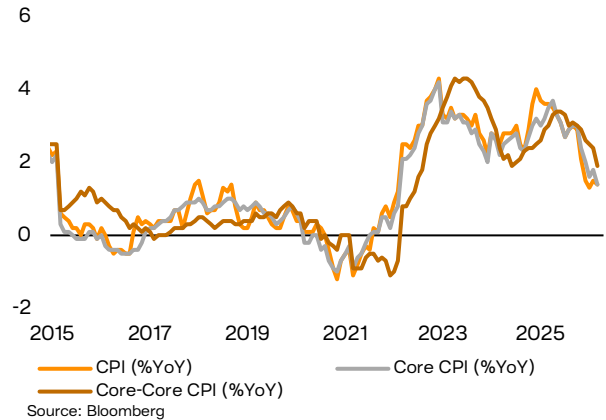
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BOJ Policy Rate (%)



Source: Bloomberg

Inflation Rate (%)

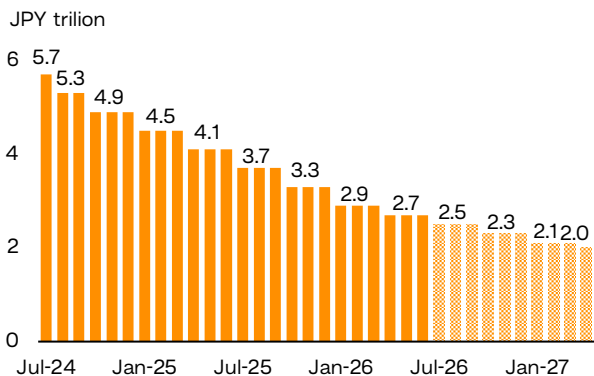


Source: Bloomberg

While the BOJ signalled its willingness to tighten further, the exact trajectory of future rate hikes remains uncertain. On the outlook for policy trajectory, the BOJ indicated that it will continue raising interest rates as underlying inflation approaches its 2% target. The BOJ also updated its assessment of financial conditions to "accommodative". Notably, compared to the March statement, the phrase "real interest rates are at significantly low levels" was revised to "real interest rates have been negative". During the press conference, Deputy Governor Uchida stated that "it's hard to judge now when our policy rate will achieve levels deemed neutral to the economy". This rhetoric suggests that while the BOJ remains committed to gradual tightening, policymakers may believe the current policy rate is moving closer to its neutral levels.

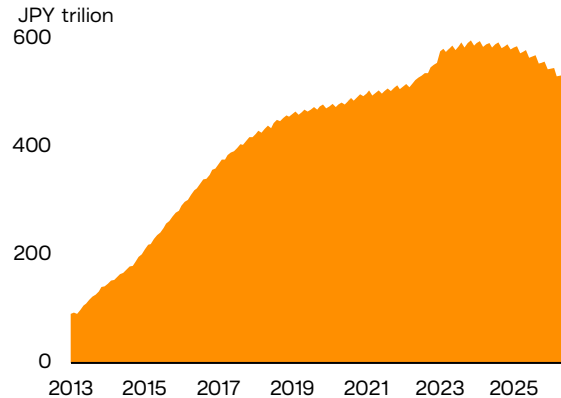
The BOJ decided to pause the tapering of its Japanese Government Bond (JGB) purchases. In the meantime, the BOJ decided to retain its JGB purchase plan by reducing monthly purchases by JPY 200 billion each quarter until March 2027 but announced that it will subsequently stabilise its monthly purchases at JPY 2 trillion. Deputy Governor Uchida explained that "bond market function has improved significantly, so there was less need to keep tapering". Regarding the duration of this plan, he added that "we haven't set in advance how long we will keep buying at 2 trillion yen per month... But that could change depending on progress domestic investors make in adjusting their portfolios". On balance, this move is anticipated to provide the market with greater certainty on the BOJ's future bond purchases, easing some upward pressure on JGB bond yields.

BOJ's Monthly JGB Purchases



Source: The Bank of Japan

BOJ holdings of JGB



Source: CEIC

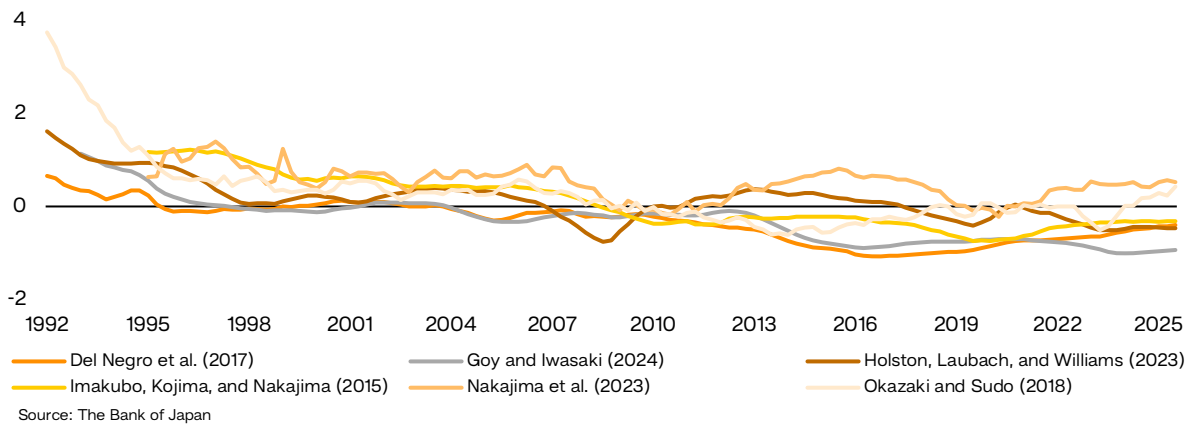
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Negative real interest rate confirms that monetary conditions remain accommodative. Although the BOJ raised its policy rate to a near three-decade high, the rate level of 1.0% sits well below Japan's key inflation readings, even after accounting for the effect of the government's subsidies. Thus, Japan's real interest rate remains firmly below zero. This accommodative posture stands in contrast to the restrictive policies of other major central banks. Such ongoing policy divergence could partly explain the persistent weakness of the JPY throughout the BOJ's gradual tightening cycle. Given that the BOJ estimates Japan's neutral rate to reside between 1.5% and 2.5%, further rate hikes remain the BOJ's core policy stance, though the pace of future policy normalisation is widely expected to be gradual.

Looking ahead, further rate hikes remain likely as inflation continues to be the central bank's primary concern. In addition to elevated oil prices, Deputy Governor Uchida expressed concern that a weaker yen could increasingly fuel underlying inflation. As such, continued depreciation could act as a potential catalyst for future monetary tightening. However, this hawkish policy tilt could face rising political headwinds from the Takaichi administration, which has publicly opposed the idea of rate hikes that could threaten economic growth. Currently, derivative markets are pricing in almost one additional rate hike by the end of 2026. The ultimate rate trajectory will hinge on the interplay between price pressures and domestic political tolerance.

Different Model Estimations of the Real Natural Rate of Interest by the BOJ



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