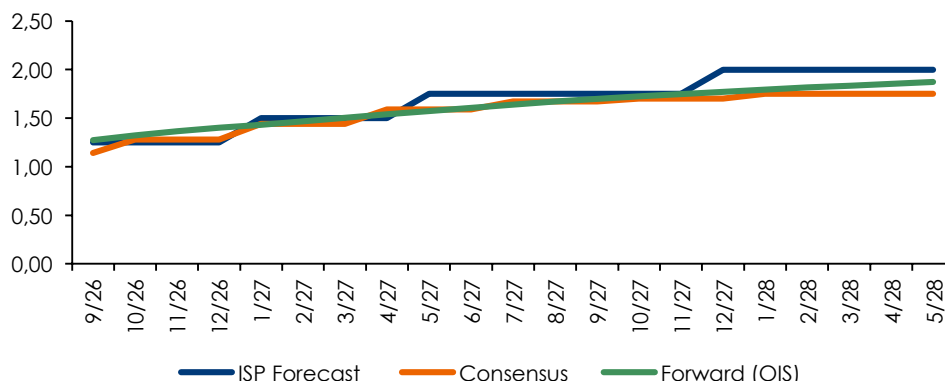


Focus Japan
BoJ preview: after September, the real economy decides the pace of further hikes
15 September 2026

We expect the Bank of Japan to raise its policy rate by 25bp to 1.25% on 18 September, three months after the June hike - the shortest interval of this cycle. The coordinated US-Japan intervention, Washington's open call for higher Japanese rates and the hawkish turn in the Board's communication leave the Bank little room to pause without appearing to tolerate yen weakness. At the same time, wages, producer prices and expectations point to inflation above 3% by early 2027. With consumers retrenching and business failures rising, however, the Bank will weigh every further step against the cost to the economy. Looking forward, we see a gradual path for the current monetary policy cycle, with an endpoint of rates at 2% by end-2027.

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- **The summer events unfolding turned a September hike into the base case.** Takata dissented in July in favour of a hike, Governor Ueda promised to weigh upside price risks from the next meeting, and the first joint US-Japan yen purchase since 1998 came with open pressure from Washington for higher rates. A pause would now read loudly as tolerance of yen weakness, so the Bank has little choice but to tighten.
- **The composition of the Board favours some hikes front-loading.** Takata and Tamura, the two most hawkish members, leave in July 2027 and their successors will be Takaichi nominees, so the current majority has the votes and, with inflation peaking near 3.5% in early 2027, the evidence to move twice before the summer. Our current expected profile on BoJ rates sees 1.50% by March, 1.75% by June and 2.00% by end-2027.
- **Published headline inflation understates the real price pressure.** Subsidies and free education hide about half a point, so the Bank's own gauges already sit above 2%, while producer prices at a three-year high, firms passing on two thirds of their cost increases and the highest household inflation expectations since 2006 point to inflation peaking at 3.5% by early 2027. Base pay rising near 3% makes that pace sustainable without help from energy or the yen.
- **The Bank will stay mindful of higher rates' consequences to the economy.** Growth has held up thanks to exports and public spending, but consumers are retrenching, business failures are at a record and transmission through floating-rate mortgages and small-firm loans is untested after two decades of near-zero rates. We therefore expect a hold through December, with every further step weighed against the cost to domestic demand.

We expect the BoJ rate at 1.25% next week and reaching a plateau at 2.00% by end-2027


Source: Intesa Sanpaolo, LSEG Datastream

Based on information available up to 15 September 2026

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After September, the real economy decides the pace of further hikes

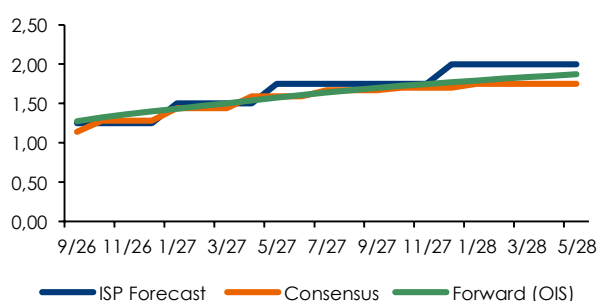
We now see the Bank of Japan normalising policy faster than we expected before the summer: we think a 25bp hike to 1.25% on 18 September has become the base case. On 31 July the Board held rates at 1.0%, but Takata dissented in favour of 1.25%, arguing that the situation had entered "a new phase" that requires "a nimble approach" to upside price risks, and Governor Ueda promised to debate policy with those risks in mind. The same day Washington raised the stakes, as the US Treasury joined Japan in a coordinated yen purchase for the first time since 1998. Treasury Secretary Bessent has since said repeatedly that Japan should end its reflationary policy because "the era of deflation is over", pressing Governor Ueda at the G20 on the need "to anchor inflation expectations and avoid excess currency volatility". In our view, this matters for two reasons. First, US support for the yen is conditional on the BoJ doing its part, so a pause would undo the intervention and invite a renewed slide; secondly, the Takaichi government, long wary of higher rates, signalled in August that it favours a near-term hike, which removed the domestic obstacle and aligned the JGBs more towards U.S. wishes. Deputy Governor Himino added on 27 August that "raising rates in a timely manner will help avoid inflation acceleration and abrupt rate hikes in the future" and that the Bank must now weigh the possibility of underlying inflation exceeding 2%. Takata even floated a larger step on 2 September, which we do not consider realistic. Himino in his recent speech reiterated that a weak yen feeds into consumer prices faster and more fully than before and also lifts inflation expectations, so the longer the currency stays near 160, the more it raises underlying inflation and not only import costs. As a result, we believe the Bank has few options left other than a strong tightening bias for the upcoming meeting.

We think the composition of the Policy Board favours front-loading the normalisation into the first half of 2027, before the two most hawkish members leave. The Takaichi government has already named Asada and Sato on the Board this year, and both currently lean accommodative, with Asada alone voting against the June hike. The hawkish wing rests on Takata and Tamura, who pressed for a hike in April and contested the inflation wording in July. However, both leave in July 2027 and their successors will be Takaichi nominees, **so the Board's centre should then shift toward caution.** We expect the September hike to pass with at least seven votes and dissent confined to the hard-doves. This is also why we expect a front-loaded path, with 1.50% to be reached in the first quarter of 2027 and 1.75% by June, since the current majority has the votes and, with inflation peaking near 3.5% in the first quarter, the evidence to move twice before the summer. **The last step to 2.00% should come in the fourth quarter of 2027, and we see that level as the terminal rate.** At 1% today, with underlying inflation near 2%, the real rate is about -1%, and bank lending growing above 5% confirms that conditions remain accommodative. The Bank's staff put nominal neutral at 1.1-2.5%, which with expectations at 2% means a real neutral rate of roughly -0.9% to +0.5%, so close to zero. A 2% policy rate takes the real rate from -1% to zero, and that is where accommodation ends. We see no case for going beyond it, since the output gap is only slightly positive and the extra wage pressure comes from labour shortages, which higher rates cannot relieve.

Domestic and external factors put September in play

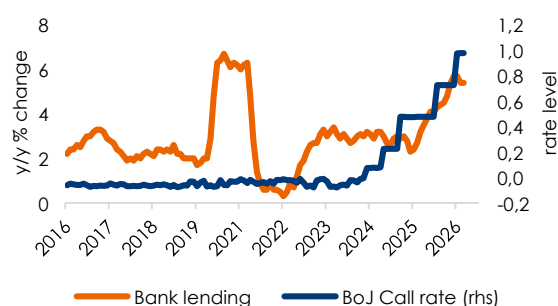
BoJ Board will lean more dovish from mid-next year

Fig. 1 – We expect BoJ rate at 1.25% next week and a plateau at 2.00% by end-2027



Source: Intesa Sanpaolo, LSEG Datastream

Fig. 2 – Lending growth above 5% at a 1% policy rate leaves room to reach 2% before conditions turn restrictive.

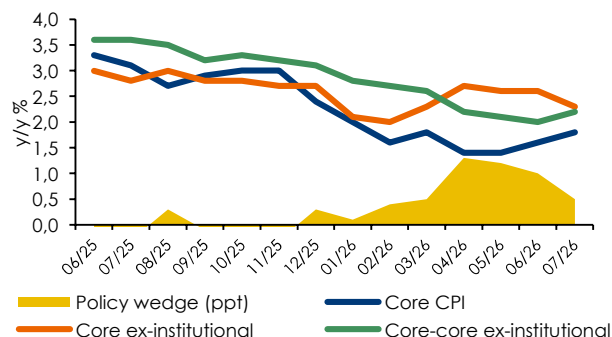


Source: Intesa Sanpaolo, BoJ, LSEG Datastream

Headline inflation has risen for three consecutive months and we expect it to head toward 3.5% by early 2027. Headline inflation rose to 1.9% in July from 1.6% in June, core to 1.8% and core-core to 1.9%. **However, government measures are keeping the prints low.** The gasoline tax cut alone shaved 0.2 pp off July inflation, electricity and gas subsidies remains in place, and free school lunches and tuition depress education prices. The Bank's own indicators strip out these institutional factors and show inflation at 2.3% ex fresh food (core) and 2.2% ex fresh food and energy (core-core), **so policy is hiding about half a point of inflation.** They were near 2.7% in the spring, and the decline since then is entirely due to energy. However, the diffusion index is little changed, with 72% of items rising against 23% falling in July. **Risks are skewed to the upside** because upstream prices, which reach consumers with a lag, are rising far faster than consumer prices. The PPI rose 7.2% in July, a three-year high, and import prices are up almost 30% on the year. In the June Tankan survey, firms expecting to raise their selling prices outnumbered those expecting to cut them by 33 points, against 52 points for input prices, so firms are passing on roughly two thirds of their cost increases. Additionally, household inflation expectations are the highest since 2006. We see headline inflation at 2.7% in the fourth quarter, as the electricity and gas subsidies end this month (unless extended again), higher crude costs feed into energy tariffs with a lag and food price rises pass through, and 3.5% in the first quarter of 2027, when the comparison with the subsidy-depressed prices of early 2026 adds close to a point to the annual rate. The food consumption tax cut from April 2027 should pull headline inflation down again to 1.7% in the second quarter, but this is a one-off shift in the price level rather than a change in the trend, as inflation excluding the tax effect would still run close to 3%, **and since the Bank treats tax changes as an institutional factor we believe it will look through the cut and continue its hiking cycle.**

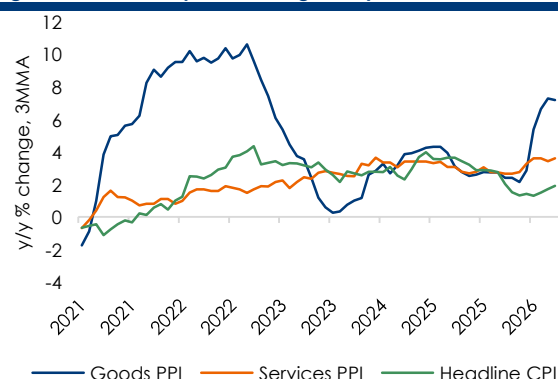
Official inflation understates price pressures

Fig. 3 – As subsidies roll off, published core should converge on the Bank's ex-policy gauges and head above 3% by Q1 2027



Source: Intesa Sanpaolo, LSEG Datastream

Fig. 4 – Producer prices at a three-year high point to further pass-through into consumer prices through early 2027



Source: Intesa Sanpaolo, LSEG Datastream

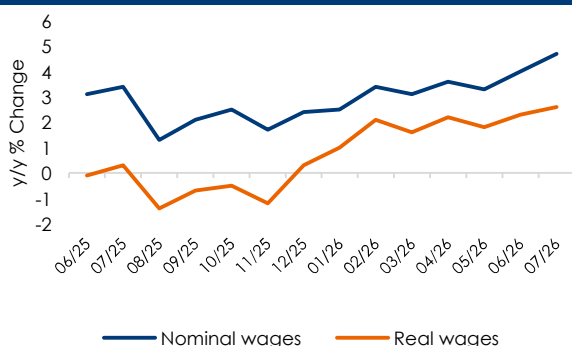
We believe wages are now rising fast enough to sustain 2% inflation without help from energy prices or the weak yen. The labour market is the tightest since the 1990s "bubble years" in the Bank's own words, with unemployment at 2.4% in July and the Tankan employment index, which nets firms reporting excess staff against those reporting shortages, at -37. For the Bank this matters because the economy is short of workers rather than short of demand, so firms compete for staff by raising pay and pass those wages on to prices, and inflation can persist even while growth stays modest. Nominal cash earnings rose 4.7% in July, the fastest since 1997 and a sixth month above 3%, and base pay rose 4.1%. The common-sample measure, which tracks the same establishments over time and is the reading the Bank weighs most, shows base pay growing near 3%, after a third consecutive shunto above 5%. Wages rising 3-3.5% while productivity grows less than 1% mean that labour costs per unit of output rise 2-2.5% a year, and since services prices are mostly labour costs, that pace is enough to keep services inflation near 2% on its own once the energy shock has passed.

Wage dynamics consistent with sustainable 2% inflation

The economy has absorbed the energy shock better than we expected, but the resilience was mostly due to external demand, public support and one-off factors. GDP grew 1.4% q/q annualised in the second quarter after 1.9% in the first, but the composition was weak. Private consumption was flat and capex fell -0.9%, so growth came from government consumption, up 6.9% annualised as the state took over school-lunch costs, and from net exports, which added half a point. That contribution is less impressive than it looks, because Japan met part of its oil needs from its own reserves, so imports fell while the same drawdown counted as a fall in public inventories, and the two largely cancel out, leaving a domestic economy that is stalling and kept afloat by exports and public spending. External demand remains the strong leg, with exports up 23% y/y in July, the fastest since 2022, driven by chips and cars. With business sentiment at multi-decade highs in the June Tankan survey, profits at a record and machinery orders up 17% on the year, we expect capex to rebound in the second half as postponed projects resume. However, rate normalisation is beginning to leave scars. Business failures reached a record 556 in the first half of the year and 121 in July alone, as higher rates reach a society used to two decades of near-zero borrowing costs and the pain concentrates in small firms. Alongside, consumer demand is the fragility. The rising cost of food and daily necessities pushed households to cut discretionary spending, and real household spending fell -3.6% y/y in July, an eighth consecutive decline, as households in our view read the real wage gains as fragile, since they rest on subsidies that lapse in the fourth quarter, and prefer to save. In fact, we expect private consumption to slow through the winter, before the food tax cut lifts it again from April next year. Against this backdrop, we think the Bank will remain very mindful of domestic conditions to avoid unnecessary stress on firms and investment, since transmission through floating-rate mortgages and SME loans is untested and Governor Ueda has said the Bank would assess the cumulative impact of five hikes.

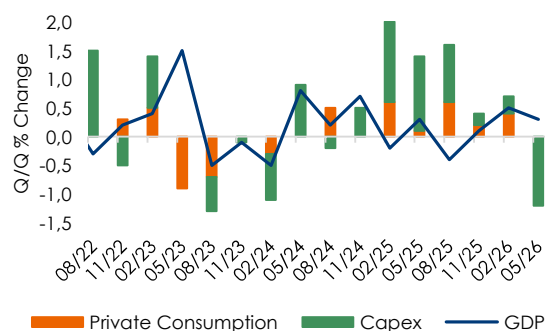
Activity resilient, consumers the weak link

Fig. 5 – Base pay near 3-3.5% is enough to sustain 2% inflation, but the real wage cushion thins once subsidies lapse



Source: Intesa Sanpaolo, LSEG Datastream

Fig. 6 – Household spending is falling for eight months and should stay soft into Q4, which keeps the Bank gradual after September



Source: Intesa Sanpaolo, LSEG Datastream

We expect a 25bp hike to 1.25% on 18 September, followed by a hold through December, with the pace of later moves set by inflation, activity and financial stability. In our view the Bank will use the October and December meetings to assess the subsidy roll-off and the transmission of past hikes and move again in the first quarter of 2027 once inflation prints above 3%. Each later decision will weigh upside inflation risks against downside growth risks and financial stability, with the 10-year yield at 3% for the first time this century. For the yen, intervention buys time only and proves short-lived without an authentic and convincing hawkish pivot. **In our view the tone on 18 September matters as much as the decision.** A true hawkish message on price stability could help tame currency pressures, while a careful reading of the economy would reassure the long end of the curve, where yields already embed a premium for fiscal risks. We see USD/JPY near 155 after the first quarter of 2027, then at 146 by end-2027, as the terms-of-trade shock fades once oil import costs normalise and the rate gap with the US narrows. The current-account surplus and a real exchange rate at its weakest since 1970, which leaves the yen far below its long-run value, work in the same direction.

The pace of further hikes will depend on how past rate rises feed through to the real economy, more than on currency moves

Appendix

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