

The BoJ's July Meeting Places Greater Emphasis on Upside Risks to Inflation

At its 30–31 July Monetary Policy Meeting, the Bank of Japan (BoJ) left the policy rate unchanged, as widely anticipated by markets, and maintained its baseline outlook that underlying inflation would converge to levels broadly consistent with the 2 percent price stability target from the second half of FY2026 through FY2027.

Although the meeting appeared uneventful at first glance, what caught my attention was the even greater emphasis placed on upside risks to inflation. Specifically, the following passage was added to the “Basic View” of the Outlook Report released alongside the policy decision: “In particular, it is important to stabilize underlying inflation at around 2 percent, from the perspective of preventing the materialization of the risk that underlying inflation will overshoot the 2 percent price stability target and subsequently have adverse effects on the economy.” In addition, the Summary of Opinions from the July meeting, released on August 10, contained numerous references to upside risks to inflation.

The BoJ highlighted three such risks: developments in the Middle East, global AI-related demand, and yen depreciation. Historically, the BoJ has distinguished between the “first force” of inflation—external cost-push factors such as commodity prices, import prices, and the exchange rate—and the “second force” of inflation—domestically driven factors such as wages, services prices, and the demand–supply balance. Policy has sought to foster a transition from the first force to the second. Recently, however, the BoJ appears to be increasingly concerned that the first force may be strengthening again.

Financial markets have already priced in a rate hike at the next (September) meeting. Yet all three cited drivers are external, their persistence uncertain, and largely uncontrollable for the BoJ. The question, therefore, is how the BoJ will articulate the logic for raising rates. The “risk of further yen depreciation if the BoJ does not hike” could be one rationale. But moving from a semiannual cadence of hikes to a quarterly pace constitutes an acceleration. The BoJ will need to explain why it is appropriate to recalibrate the degree of accommodation more quickly at this juncture. Clarifying that logic also matters for markets’ assessment of the likely terminal rate.

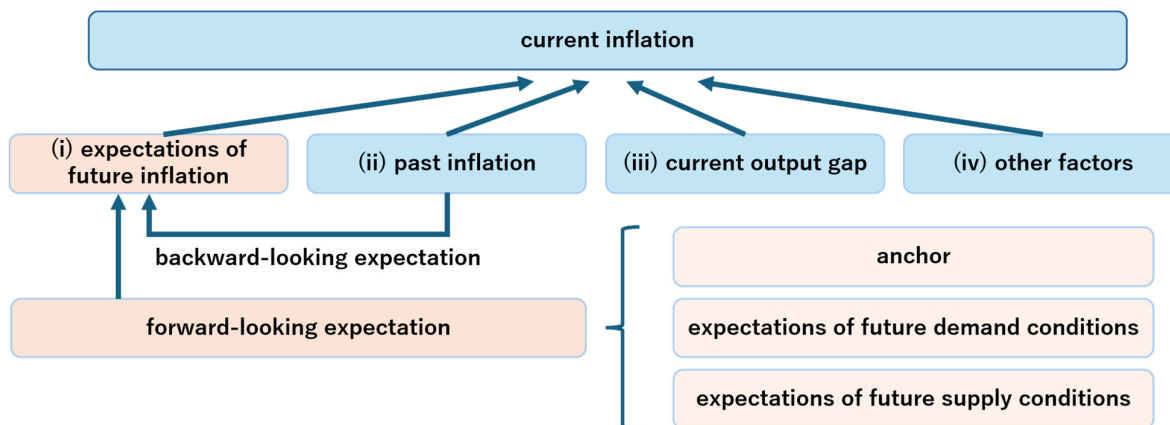
Forward-looking inflation expectations are rising in Japan

In an economic framework, current inflation can be expressed as in Chart 1 (1). In essence, “current inflation is determined by (i) expectations of future inflation (price-setting behaviors by firms and price expectations of households formed this period for next period), (ii) past inflation (the most recent realized inflation), (iii) the current cyclical economic position (the output gap), and (iv) other factors (primarily supply-side external shocks such as oil prices and the exchange rate).”

Monetary policy can influence (i)–(iii). As for (ii), recent core CPI indicators have been mixed, making it difficult to argue that upside inflation risks have clearly intensified. As for (iii), the output gap remains modestly positive but shows no sign of accelerating. By contrast, (i) inflation expectations have been rising clearly. Put simply, the BoJ is therefore likely to cite the “risk of rising inflation expectations” as a rationale when raising interest rates. However, in my view, what matters for monetary policy decisions is not merely the level of inflation expectations, but what has driven changes in those expectations. This column therefore examines the underlying nature of inflation expectations.

Inflation expectations generally comprise an “adaptive” component rooted in experience—proxied by (ii), the previous period’s inflation—and a residual component (i’), which is a purely forward-looking expectation of future inflation (2). Forward-looking expectations are shaped by the credibility of the central bank’s price target and policy—i.e., the “anchor”—expectations of future domestic demand conditions, and expectations of future supply conditions, including prospective cost shocks.

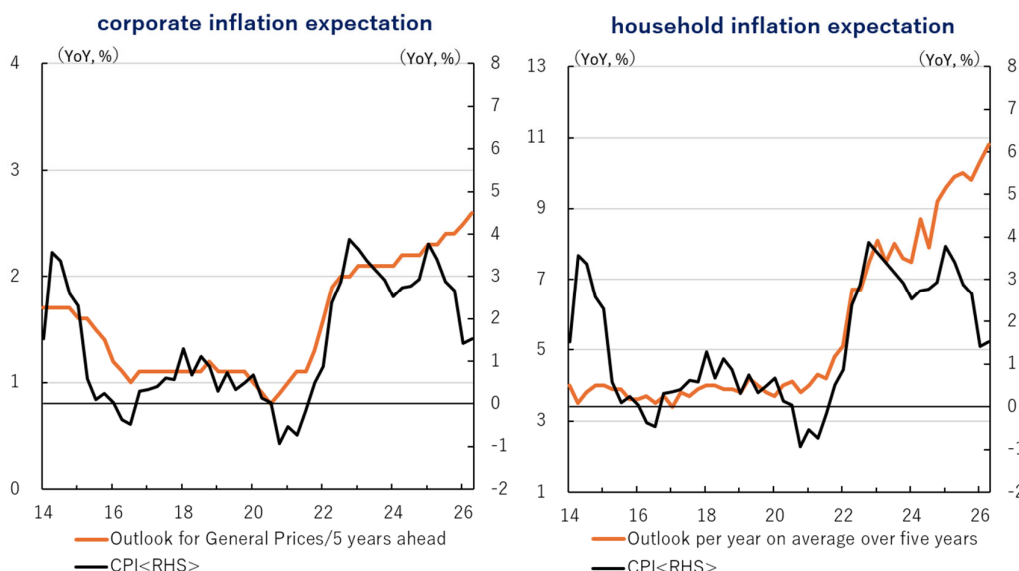
Chart 1: Interactions among inflation determinants



Source: Nomura Research Institute

Turning to medium- to long-term expected inflation among households and firms, these expectations have broadly tracked headline CPI over the long run (Chart 2). Since 2023, however, household inflation expectations have risen above and continued to outpace actual inflation. Corporate inflation expectations have also trended higher, albeit more gradually. This suggests that the recent increase in inflation expectations reflects not only adaptive dynamics but also a growing forward-looking component.

Chart 2: Corporate and household inflation expectations and actual inflation



Sources: Bank of Japan “Tankan” and “Opinion Survey on the General Public’s Views and Behavior,” Statistics Bureau “Consumer Price Index (CPI).” Compiled by Nomura Research Institute

Interpreting the rise in forward-looking expectations

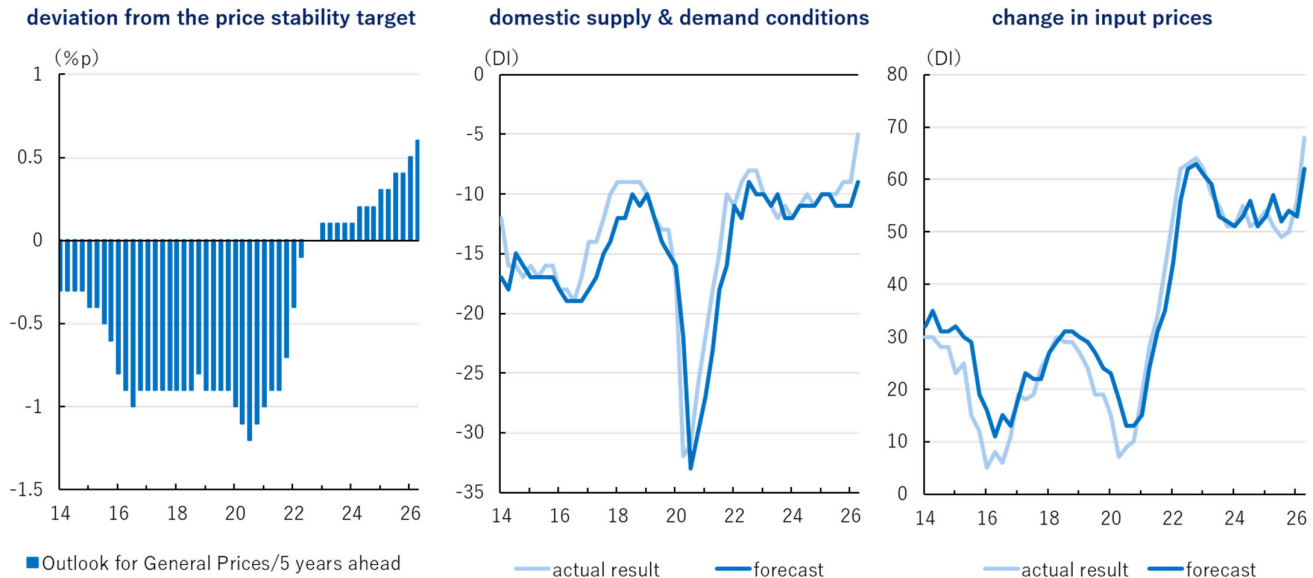
A greater role for forward-looking expectations is typically welcome. It tends to stabilize inflation expectations around the target and is consistent with the notion that monetary policy operates with lags of roughly half a year to a year and a half. Moreover, a rise in expectations toward the target is precisely what policy has sought to achieve (3).

What matters for assessment, however, is why forward-looking expectations have strengthened. The reason is that the macro effects of rising expectations on the output gap and inflation differ by driver. For example, Jinnai et al. (2021) show that consumption responds differently depending on the source of higher inflation expectations (4). Specifically, when higher expected inflation is driven by increases in food and energy prices, it does not stimulate consumption nor lift expected wages. In the United States, survey experiments presenting households and experts with different shocks found that both a supply shock (oil price increase) and a demand shock (higher government spending) raise inflation expectations, but the former is associated with expected economic deterioration while the latter is associated with expected improvement (5).

In other words, when forward-looking inflation expectations rise toward the price stability target due to a stronger anchor or expectations of future domestic demand, a benign “good expectations formation” is at work, fostering a virtuous cycle of wages and prices and improving economic conditions. This should support consumption and investment and, through stronger domestic demand, improve the output gap. Conversely, when the driver is expectations of future supply constraints—i.e., cost increases—“bad expectations formation” is at work, compressing real wages and real disposable income and lowering expected growth. Precautionary saving may also rise. In such cases, consumption and investment are likely to be postponed or curtailed, weighing on the output gap and expected growth.

To shed light on how firms and households form their expectations, Charts 3 and 4 present indicators that may capture the “anchor,” “expectations driven by demand-side factors,” and “expectations driven by supply-side factors.”

Chart 3: Firms’ “anchor,” “expected demand factors,” and “expected supply factors”

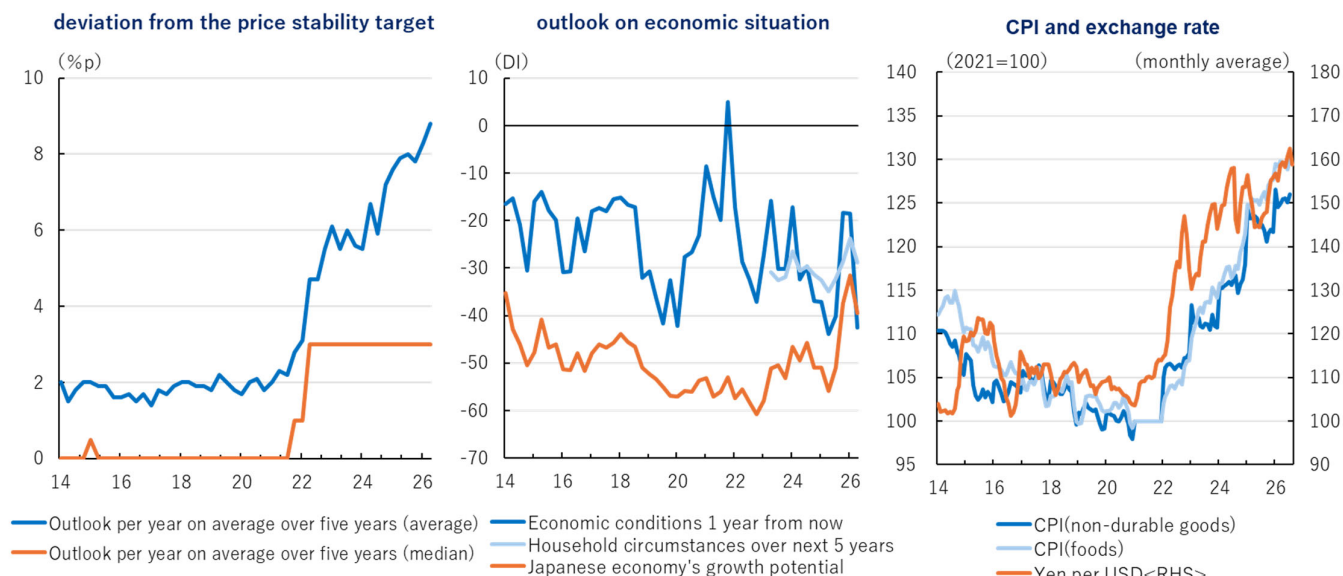


Source: Bank of Japan “Tankan.” Compiled by Nomura Research Institute

For firms, medium- to long-term inflation outlooks for “overall prices” have risen above 2 percent since 2023 (Chart 3, left). The deviation from the 2 percent target remains limited, suggesting reasonable anchoring. The Tankan Domestic Demand DI, used here as a proxy for expected demand, has been broadly flat in recent years but shows signs of edging up (Chart 3, center). As a proxy for expected supply factors, the Tankan Input Prices DI has risen somewhat more noticeably in the latest readings (Chart 3, right). Thus, although supply-side factors have risen, on balance, “good expectations” appear to be at work in the corporate sector.

Households present a somewhat different picture. Five-year-ahead inflation expectations are well above 2 percent and remain elevated (Chart 4, left). As a proxy to expected demand, we look at the BoJ Opinion Survey’s indicator of the outlook for economic conditions. While the extent of deterioration narrowed sharply in the second half of 2025, it has recently widened again—an evolution inconsistent with the continued rise in expected inflation (Chart 4, center). For expected supply factors, we use movements in food prices, where supply factors have been influential, and the exchange rate. Household inflation expectations have risen in episodes where the exchange rate has weakened significantly, and food prices have increased (Chart 4, right). In summary, households’ inflation expectations are not anchored at 2 percent, their outlook for business conditions has deteriorated, and supply-side factors predominate. This suggests that “bad expectations” are at work among households.

Chart 4: Households' "anchor," "expected demand factors," and "expected supply factors"



Source: Bank of Japan "Opinion Survey on the General Public's Views and Behavior," Statistics Bureau "Consumer Price Index (CPI)," Bank of Japan "Foreign Exchange Market" data. Compiled by Nomura Research Institute

September will be a meeting where weighing the effects and side effects of tightening becomes even more important

Assuming a rate hike is delivered in September, what effects and side effects should be expected? From the standpoint of recalibrating accommodation, the primary transmission will likely be through changes in financial intermediation behavior. Higher lending rates and tighter lending attitudes would raise financing costs for SMEs that rely on bank borrowing as well as for households' residential investment, imparting a drag on these components.

Regarding upside inflation risks, such demand restraint—especially on investment—would slow the pace of improvement in the output gap and thereby dampen domestically generated inflationary pressure. For inflation expectations, particularly on the corporate side, a hike could strengthen the anchor around the price target and modestly temper expectations of future demand, helping to contain upside risks to medium- to long-term expected inflation.

For households, however, expectations currently appear to be driven mainly by supply factors. It is uncertain whether a rate hike would directly curb household inflation expectations. There is a risk that the anchor component and expected demand could be weakened unintentionally. Even if overall expected inflation were restrained, it might not reflect "good expectations"; instead, consumption and housing demand could be damped more than intended, posing downside risks to overall economic activity.

In summary, supply-side influences still play a material role in inflation and expectations formation. With growth momentum lacking—particularly on the household consumption side—accelerating the

pace of rate hikes would simultaneously raise the risk of side effects. It would therefore not be reasonable, at this stage, to continue hiking on a quarterly cadence or to raise rates beyond the neutral rate. It would be preferable to pause and assess the effects of the hikes already delivered, and—taking into account the impact of government policies—confirm that household economic activity has become more resilient before reconsidering the pace of tightening and the eventual destination for the policy rate.

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(1) This specification is known as the hybrid New Keynesian Phillips curve. Unlike the standard New Keynesian Phillips curve, in which prices are determined by rational expectations and the output gap, it incorporates price stickiness by allowing past inflation to affect current inflation as well.

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(2) Kishaba et al. (2024), however, point out that substantial uncertainty remains regarding the mechanism through which medium- to long-term inflation expectations are formed.

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(3) Kaihatsu et al. (2024) show that an “expectations channel” may operate in Japan, whereby higher inflation expectations increase private-sector spending through, among other mechanisms, a decline in real financing costs.

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(4) T Jinnai, R., Mikami, T., Okuda, T., and Nakajima, J. (2021), “Household Inflation Expectation and Consumption: Evidence from Japan,” *The Economic Review*, Vol. 72, No. 3, pp. 268–295.

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(5) Peter Andre, Carlo Pizzinelli, Christopher Roth, Johannes Wohlfart, “Subjective Models of the Macroeconomy: Evidence From Experts and Representative Samples,” February 2022.

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