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Inflation fears could take precedence as BOJ eyes stagflation

Key takeaways

- The Bank of Japan (BOJ) held rates unchanged on 28 April, though three board members pushed for a rate hike, citing inflationary risks from the Hormuz crisis.
- The bank's quarterly outlook for the economy and prices warned of stagflation, lowering the growth outlook and raising the price outlook, but the report stressed significant upside risks for prices through several channels.
- This week's meeting suggests that the bank could be inclined to hike in June if higher inflation surfaces, which could increase pressure on the Takaichi government to address possible demand shortfalls.

The Bank of Japan (BOJ) held rates unchanged following its 27-28 April policy board meeting – as signaled by the bank in advance – as the bank seeks clarity on the balance of stagflationary risks to Japan's economy. Accordingly, while the unsuccessful push by three board members for a rate hike to 1.0% suggests that there is a minority in favor of hiking faster, Governor Ueda Kazuo's remarks on Tuesday suggest that uncertainty about the nature of the risks facing Japan's economy – whether it is more at risk of a growth slowdown or a price spike in response to the Hormuz crisis – means that it could still take weeks before the BOJ's approach to its 15-16 June policy board meeting becomes clear. Ueda himself was explicit in his press conference, saying that if it appears that the downside risks to Japan's economy are limited while the risks of higher inflation continue to mount, the bank will be inclined to hike before expectations of above-target inflation become firmly anchored, particularly since, as Ueda noted, companies have become more aggressive about hiking prices in the post-deflationary environment.

The BOJ's quarterly Outlook for Economic Activity and Prices report (*tenbō*), released Tuesday, suggests that the bank's concerns may be more weighted towards the risk of

an inflationary shock rather than a growth slowdown. While the report saw the bank revise its real GDP forecast for FY2026 downward from +1.0% to +0.5% compared to January and its FY 2026 CPI forecast upward (core CPI from 1.9% to 2.8%, core-core from 2.2% to 2.6%), the report itself suggests that the bank is more concerned about inflation than growth. The bank's baseline scenario suggests "that Japan's economy will not enter a significant adjustment phase," buoyed by government policies, high corporate profits, and healthy wage increases. The BOJ may be more concerned that an upside price shock, if unchecked, could have subsequent real economic impacts, slowing the economy "through a significant decline in corporate profits and households' real income." The multiple channels through which inflation could rise – not only higher crude oil prices but also higher food prices due to fertilizer shortages and prolonged yen weakness – could also serve to make the BOJ more sensitive to the risk of above-target inflation. The upshot is that, barring clear signs of an economic slowdown moving in advance of or in lockstep with higher inflation, the BOJ could raise rates as early as June to get ahead of price increases.

The implication of the BOJ's seemingly greater concern about above-target inflation is that the Takaichi government may face greater pressure to offset the impact of the Hormuz crisis on the real economy, if and when the impact becomes apparent. Prime Minister Takaichi Sanae has resisted calls to both promote restrictions to conserve energy supplies – an approach that polls well among both the public and economists – and pursue a supplemental budget before the end of the parliamentary session in July. She has instead continued to use a mix of diplomacy to identify alternative sources of oil, fuel subsidies to limit price increases, and releases of supplies from strategic reserves, all while downplaying growing concerns from businesses over shortages of petroleum products in particular. However, if the crisis shows no signs of abating during the coming weeks, it is likely that the government will have to change course and use fiscal policy to offset an economic slowdown even as the BOJ looks to contain higher inflation. If the stagflation anticipated by the BOJ *tenbō* unfolds, the government's popularity could take a hit for not having moved faster to cushion the impact on Japanese households.

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