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BOJ Raises Policy Rate by 0.25 Percentage Points: Policy Rate Expected to Approach 2% by Mid-2027

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This is an English version of the Japanese report "日銀が 0.25%利上げ：来年中ごろには政策金利は２％近くまで上昇と予測."

■BOJ Implements Additional Rate Hike: Japan's Shift toward a "World with Interest Rates" Gains Momentum

The Bank of Japan today decided to raise its policy rate by 0.25 percentage points. As a result, the policy rate now stands at 1.25%, making it increasingly clear that Japan's economy is entering a new phase of transition away from the prolonged ultra-low-interest-rate environment and toward a "world with positive interest rates." Expectations for further rate hikes ahead have also been rising. This report examines the assessment of the latest rate hike, the likely direction of monetary policy going forward, and its implications for the household, corporate, and government sectors.

■Policy Rate Likely to Approach 2% by Mid-2027

To state the conclusion first, the latest rate hike can be assessed as an appropriate policy decision from the standpoint of preventing inflation expectations from becoming entrenched and curbing overheating in asset prices. It is also reasonable in terms of forestalling yen depreciation, particularly as the United States implemented a 0.25% rate hike on the 16th. Monetary policy normalization is unavoidable in order to ease yen depreciation pressures stemming from interest rate differentials between Japan and overseas economies, and to contain the increase in household burdens through higher import prices. In addition, as stock prices and real estate prices in central Tokyo continue to rise, signaling a tightening stance is important to preempt the risk of future bubble formation. Given that inflation expectations among markets, firms, and households have risen above 2%, it is highly significant for the BOJ to demonstrate a strong commitment to price stability.

In the conduct of monetary policy going forward, it will be necessary not only to raise the policy rate in nominal terms but also to lift real interest rates from negative territory to an appropriate level. From this perspective, one benchmark scenario would be for the BOJ to raise rates by 0.25 percentage points at intervals of around three months, bringing the policy rate to roughly 2% by mid-2027. Given that abrupt changes in financial conditions could destabilize markets, the BOJ will need to communicate carefully its economic and price outlook as well as its policy reaction function, and further strengthen dialogue with market participants.

At the same time, attention should be paid to concerns over so-called fiscal dominance, whereby fiscal management constrains the independence of monetary policy. As the government strengthens its expansionary fiscal stance, a situation must be avoided in which priority is placed on low-cost government bond financing to such an extent that the central bank hesitates to implement sufficient monetary tightening. Progress in inflation can push up nominal GDP and thereby contribute to lowering the government debt-to-nominal-GDP ratio targeted by the government. Excessive inflation, however, would erode living standards. Moreover, if inflation expectations rise further, market interest rates could increase by more than the inflation rate, raising interest payments and potentially worsening the fiscal position instead.

In the latest Basic Policy on Economic and Fiscal Management and Reform of the Takaichi adminisitration, the government indicated its intention to respect the independence of the BOJ. To achieve both price stability and fiscal consolidation, it is essential that this stance not remain merely a policy statement, but be thoroughly reflected in actual policy management.

■Sectoral Impacts: Limited Effects on Households and Firms Overall, but Risks of Wider Disparities Warrant Attention

From a sectoral perspective, the impact of higher interest rates is not necessarily negative across the household sector as a whole. Higher returns on deposits, savings, bonds, and other financial assets are expected to increase interest income. Japanese households, in aggregate, hold substantial net financial assets, and rising interest rates therefore have the potential to boost asset income. In the corporate sector as well, given the accumulation of retained earnings and progress in passing higher costs through to prices, the downward pressure from the latest rate hike is likely to remain limited overall.

That said, the effects will not be uniform. In the household sector, concerns center on the increased burden on working-age households with large outstanding mortgage balances, particularly those that purchased homes in urban areas where real estate prices have risen sharply. In the corporate sector, earnings could come under greater pressure among small and medium-sized enterprises with a high dependence on borrowing, as well as in interest-rate-sensitive industries such as real estate and retail. Accordingly, while monetary policy normalization should proceed, targeted policy support will be needed for vulnerable borrowers and firms, including appropriate liquidity assistance and support for business restructuring.

The most pronounced impact of rising interest rates, however, will be felt in the government sector. With upward pressure on long-term rates in addition to higher short-term rates, the risk of a sharp increase in government bond interest payments is rising further. If interest rates continue to climb, annual interest payments could expand from around ¥10 trillion at present to more than ¥20 trillion by around 2030. Japan is moving from an era in which fiscal consolidation could be postponed on the assumption that low interest rates would persist, to one in which expenditure and revenue reforms must be pursued on the premise of rising rates. In today's inflationary environment, the situation is entirely different from the deflationary period in which Abenomics was implemented. The government should recognize that fiscal management reliant on ultra-low interest rates is no longer sustainable and should promptly present concrete measures toward fiscal consolidation.