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Mizuho Economic Outlook & Analysis

July 25, 2024

How will the Japanese economy be affected by rising interest rates?

The impact of a "0.5% rate hike" on the economy

< Summary >

◆ Assuming the Bank of Japan raises the policy interest rate to 0.5% after September, creating a base scenario of a "world with interest rates" (with long-term interest rates rising to around 1.5%), we have estimated the impact on the macroeconomy, households, businesses, and government.

◆ Given the rise in expected inflation, the impact on GDP is forecast to be limited at about -0.1%. While households as a whole will see an annual income rise of around 1.5 trillion yen, households in their 20s to 40s with significant mortgage debt will face a larger net burden.

◆ Sectors with significant debt, such as the corporate and government sectors, will likely experience negative impacts. For the corporate sector, especially small and medium-sized companies, increased interest payments will cut earnings by 1.3%. For the national government, the evaporation of the interest rate bonus will require improvements in the primary balance (PB).

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1. The Bank of Japan will likely raise interest rates to 0.5% after September, with long-term interest rates climbing to the mid-1% range

Japan has long experienced a "world without interest rates" with short-term rates in the negative territory and long-term rates sitting at zero, but the nation is now on the verge of re-entering a "world with interest rates." With rising labor costs due to wage hikes and higher logistics costs amid labor shortages, coupled with a depreciating yen, inflationary pressures are expected to increase across a wide range of items, including services. Consequently, there is growing market speculation that the Bank of Japan will raise interest rates sometime this year.

According to the Monthly Labour Survey for May, the nominal wage growth rate (common establishment basis) was +2.3% year-on-year (April: +1.8%) and the scheduled earnings growth rate +2.7% (April: +2.2%), both marking a significant increase. With the results of the spring wage negotiations (headline wage hikes in the 5% range, base wage increases in the 3% range) spreading more fully from the summer onwards, nominal wage growth in the 3% range is envisaged. Regarding price trends, the Bank of Japan's core CPI (all items excluding fresh food and energy) for June rose by +2.2% year-on-year (May: +2.1%), and accelerated on a seasonally adjusted basis by +0.3% month-on-month. The prices of household durable goods rose on the back of the yen's depreciation, and the prices of services, which peaked at +2.3% year-on-year in November-December 2023 and continued to retreat with the loss of the "first force" accompanying the pause in rising import prices, also expanded again to +1.7% year-on-year (May: +1.6%), reflecting a break in the deceleration trend in dining and lodging where cost pass-through is becoming the norm, driven by increased inbound tourism. (Looking at a month-over-month comparison, June shows signs of an acceleration in services such as medical treatment, nursing care, and general food services, in addition to durable consumer goods.) The "second force" of "wages to prices" is not yet sufficient to achieve the 2% inflation target. But the Bank of Japan is likely to raise rates twice between September 2024 and March 2025, according to Mizuho Research & Technologies (2024), after assessing macro wage trends, including those of small and medium-sized companies, corporate price shifts and service price trends, and consumer spending trends over the summer. (We expect no change in the policy rate at the July monetary policy meeting.)

Mizuho Research & Technologies (2024) predicts both core CPI and the Bank of Japan's core CPI to fall below 2% year-on-year by FY2025, given the impact of easing import prices and a slowdown in wage hikes due to reduced corporate profits. [1]

[1] MHRT (2024) predicts that corporate earnings in FY2024 will significantly decelerate due to downward pressure from rising labor

Consequently, the hurdle to achieving the Bank of Japan's 2% inflation target remains high. Meanwhile, if the policy rate is raised to 0.5%, as Kawata (2024) points out, and if the neutral interest rate estimated in the mid-1% range (with the natural rate of interest at 0% and expected inflation in the mid-1% range), it would be less than half that level, allowing for the assertion of a "loose monetary environment." With the policy rate hike, long-term rates are expected to rise to around 1.5% by FY2025. (Along with raising interest rates, the Bank of Japan's reduction of JGB purchases is expected to contribute to higher long-term interest rates, but we assume that the Bank of Japan will flexibly adjust the pace of its JGB purchases to avoid a sharp rise in long-term interest rates.) Additionally, ordinary deposit rates are forecast to rise to 0.1%, 10-year fixed deposit rates to 1.1%, variable mortgage rates to 0.9%, and fixed mortgage rates to 2.7% by FY2025 (**Chart 1**). Similarly, corporate debt interest rates are thought to rise to 1.9%, and asset returns to 3.2%.

Chart 1: Market and various interest rate indicators in the base scenario of a "world with interest rates"

		FY2023	FY2024	FY2025
Market	Policy interest rate	-0.05%	0.28%	0.50%
	Long-term interest rates	0.625%	1.28%	1.53%
	JPY/USD rate	144 yen	152 yen	141 yen
		FY2023	FY2024	FY2025
Household	Ordinary deposit	0.001%	0.04%	0.1%
	Time deposit (10 years)	0.4%	0.9%	1.1%
	Mortgage (variable)	0.3%	0.5%	0.9%
	Mortgage (fixed)	1.8%	2.5%	2.7%
Corporate	Debt interest rate	1.2%	1.7%	1.9%
	Asset return	2.7%	3.0%	3.2%

Notes: 1. The average value for each fiscal year. Variable mortgage rates are post-preferential rates. The policy interest rate is assumed to be the uncollateralized overnight call rate, and long-term interest rates are assumed to be 10-year government bond yields.
2. Deposit rate sensitivity is calculated based on approximately 30 years of past data, and mortgage rate sensitivity is based on data from the early 2000s up to the introduction of negative interest rates. Ordinary deposit rates consider current market conditions.
Source: Made by MHRT based on the Bank of Japan and various materials.

In this report we examine the impact on the Japanese economy if the Bank of Japan

costs associated with wage increases, and higher interest payments due to rising interest rates. As the corporate capacity for wage increases and investments diminishes, it is highly likely that the wage increase rate for 2025 will slow to the upper 3% range.

raises the policy rate to 0.5% and long-term rates rise to around 1.5%, based on Mizuho Research & Technologies (2024) forecasts. While Miyazaki et al. (2023) considers a risk scenario with policy rates rising to 2.75% and long-term rates to 3.5%, this report is based on a more realistic base scenario of a "world with interest rates." The following sections consider the impact on the macroeconomy, households, businesses, and government (fiscal) based on the assumed interest rate indicators mentioned earlier.

2. Impact on the macroeconomy: GDP impact limited to around -0.1%

First, regarding the impact on the macroeconomy, the rise in short-term rates due to the rate hike will dampen capital investment and housing investment. However, considering the time lag before the rise in interest rates affects capital and housing investments, even if an overall rate hike of 0.5% is implemented in FY2024 (assumed to be twice, in September 2024 and in March 2025), the impact will mainly become apparent from FY2025 onwards.

While short-term rates rise, if sustained wage and price increases lead to higher inflation expectations, the rise in real interest rates will be restrained. The Bank of Japan's Opinion Survey on the General Public's Views and Behavior and the Tankan survey (Short-Term Economic Survey of Enterprises in Japan) show that household and corporate short-term (one year ahead) and medium- to long-term (five years ahead) inflation expectations are trending upward, which seem to reflect gradual changes in corporate wage and pricing behaviors (norms). Currently, assuming that short-term rates rise by 0.5%pt, medium-term inflation expectations rise by 0.3%pt (compared to previous assumptions), and real rates rise by around 0.2%pt, real GDP for FY2025 is expected to fall by around -0.1% (**Charts 2 and 3**. Mizuho Research & Technologies (2024) anticipates that the Bank of Japan's core CPI year-on-year rate for the medium term from FY2025 onward will exceed the February forecast (around 1.2-1.3%) by approximately +0.3%pt, reaching around 1.5-1.6%, taking into account the realization of higher-than-expected wage increases in 2024. This expectation is consistent with the "composite index of inflation expectations," calculated based on the inflation expectations of households, companies, and experts, and recently rising to about 1.6%. The impact of rising interest rates on the real economy was estimated using multiples from the Cabinet Office's macro model.)

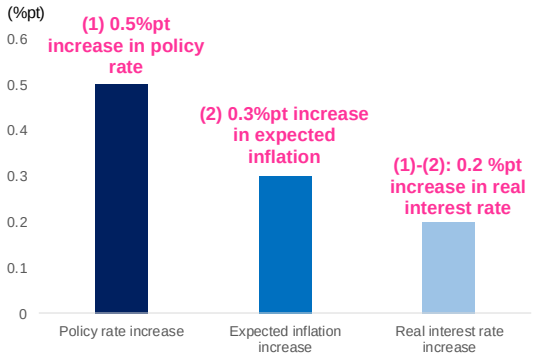
As shown in **Chart 3**, considering the positive impact on household asset income, personal consumption is expected to increase slightly, offsetting the decline in housing investment (a detailed analysis of household interest income and expenditure is provided in section 3). For businesses, interest rate increases and the yen's appreciation will likely reduce earnings, thereby dampening capital investment (a detailed analysis of the impact

on corporate profits is provided in section 4).

Mizuho Research & Technologies (2024) forecasts that the Japanese economy in FY2025 will continue to see positive real wages year-on-year for consumer spending to maintain a recovery trend, as well as an upward trend in capital investment due to higher-than-expected company growth rates and moves to strengthen domestic production bases, despite rising interest and labor costs putting downward pressure on corporate earnings. Even taking into account the negative impact of the above-mentioned interest rate hikes, we believe that Japan's economy will avoid a backslide. (Mizuho Research & Technologies (2024) forecasts real GDP growth of +0.8% year-on-year in FY2025, after factoring in the downward pressure of higher interest rates.)

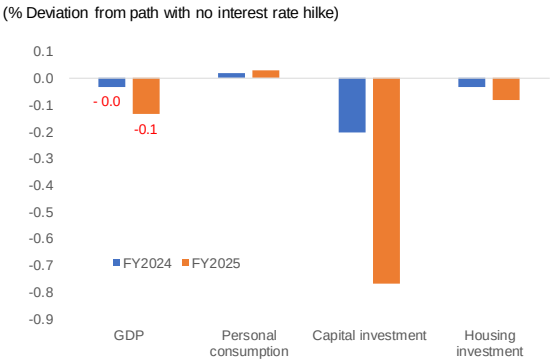
While a 0.5% rate hike is not expected to have a significant impact on the macroeconomy, the degree of impact will vary among various sectors of the economy. In particular, sectors with significant debt will face noticeable negative impacts (interest rate increases resulting in a redistribution from debt-holding sectors to asset-holding sectors). The following sections examine the impact on household, corporate, and government (fiscal) sectors in detail.

Chart 2: Rise in real short-term interest rates (compared to previous forecasts)



Note: Inflation expectations reflects the assumptions made in Mizuho Research & Technologies (2024) where core CPI and the Bank of Japan's core CPI rise by +0.3%pt in the medium term compared to forecast in February, and track in the mid-1% range.
Source: Made by MHRT.

Chart 3: Impact on GDP and demand components



Notes: The estimate uses multiples from the Cabinet Office's macro model, taking into account the time lag until the impact of the interest rate hikes becomes evident.
Source: Made by MHRT based on the Cabinet Office and other sources.

3. Impact on households: an overall income increase, but negative for mortgage-holding households

(1) Positive impact for households as net asset holders: annual income increase of around 1.5 trillion yen

This section examines the impact on households using the analytical framework of

Nakanobu and Nishino (2024). For details on the estimation methods and concepts, refer to their analysis.[2] From the asset side, the overall image suggests that (i) higher returns on financial assets like deposits and securities, and (ii) a shift in household funds to more profitable assets, will lead to an increase in income from financial assets.

Specifically, as shown in **Chart 1**, ordinary deposit rates are expected to rise only modestly to around 0.1% even if the policy interest rate rises to 0.5%. However, time deposit rates are expected to increase more significantly, leading to a shift from ordinary deposits to more attractive time deposits. For securities, an increase in the holdings of government bonds and equities/investment trusts is assumed. Especially for equities/investment trusts, since stock prices tend to track economic growth and inflation rates over the long term, they become more attractive as assets that do not depreciate in value under inflation. Increased holdings of equities/investment trusts, coupled with corporate profit growth, will have a positive impact on households as it leads to higher dividend income. In addition to the simple effect of rising deposit rates, these portfolio reallocation effects will significantly improve asset profitability, resulting in households benefiting through increased interest and dividend income.

It is also important to consider the rise in mortgage rates. As shown in **Chart 1**, while both short-term and long-term interest rates will rise during the phase of interest rate hikes, mortgage borrowing rates are expected to rise in general, since a rise in short-term interest rates will affect variable-rates, and long-term interest rate hikes will affect fixed-rates. With the Bank of Japan's ultra-loose monetary policy restraining short-term interest rates, the proportion of variable-rate loans in new mortgage lending has risen to 80%, implying that an increase in short-term rates will quickly lead to higher interest payments. As the awareness of rising interest rate risks spreads among households, a gradual shift to fixed-rate loans is expected, with the impact of rising long-term rates on household income becoming apparent after some delay.

Overall, studying the asset-side and liability-side effects, the positive impact on household income is expected to outweigh the negative impact of rising mortgage rates (**Chart 4**). Households own approximately 2,200 trillion yen in financial assets (including around 1,100 trillion yen in cash and deposits) compared to approximately 400 trillion yen in financial liabilities, making households net asset holders overall. Therefore, the positive effect on the asset side clearly outweighs the negative effect on the liability side. The base

[2] Based on economic assumptions (such as the degree of interest rate increase) different from Nakanobu and Nishino (2024), several adjustments were made to the estimates. For example, while Nakanobu and Nishino (2024) assume that the proportion of variable-rate mortgages would decrease from the current 80% to 20% with rising interest rates, this report assumes that short-term interest rates and variable rate increases will not be as significant, leading to a decrease to only 50%. Additionally, considering the differences in assumptions for economic growth rates and long-term interest rates, the dividend and distribution yields for stocks and investment trusts are assumed to be slightly lower than those of Nakanobu and Nishino (2024).

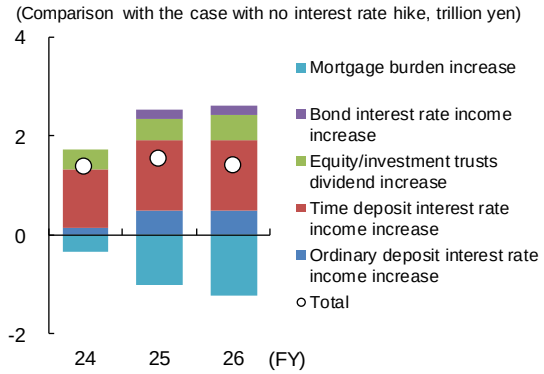
scenario of a "world with interest rates" is expected to result in an annual income increase of around 1.5 trillion yen by FY2026. However, this estimate assumes a certain degree of investment in more profitable financial products like time deposits and equities/investment trusts. If households continue to hold a large proportion of ordinary deposits, the negative impact of rising mortgage rates could exceed the positive impact of higher asset returns.

(2) Negative impact larger for mortgage-holding households

It is important to note that the positive impact on "households as a whole" does not mean a positive impact on "all households." The macro impact mentioned earlier includes households that have not purchased homes or have already paid off their mortgages. For households with mortgages, the negative impact is expected to be larger.

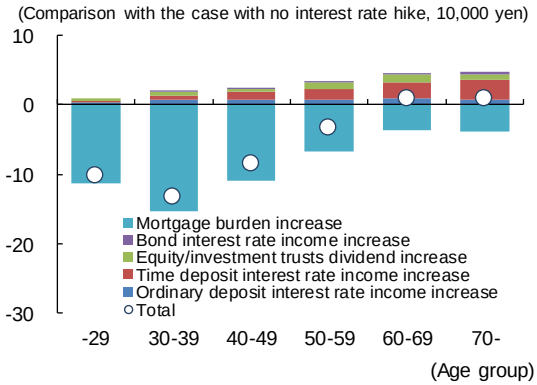
When estimating the impact on mortgage-holding households, the net increase in interest payments will exceed the increase in asset income for households in their 20s to 40s with large mortgage balances, resulting in an overall negative impact on income (**Chart 5**). On the other hand, for those in their 60s and older who have mostly paid down their mortgages, the positive impact will slightly exceed the negative impact. Not shown in this chart, households without mortgages or have paid them off will enjoy the positive effect of improved asset profitability. While the overall impact on "households as a whole" is expected to be positive, it is important to consider the varied effects on different household attributes.

Chart 4: Impact on household property income (macro)



Note: Based on the analytical framework of Nakanobu and Nishino (2024), "Is an interest rate rise positive for households?"
Source: Made by MHRT based on data from the Ministry of Internal Affairs and Communications, Cabinet Office, and Bank of Japan.

Chart 5: Impact on income of debt-holding households (per household)



Notes: 1. Total value for FY2026.
2. Based on the analytical framework of Nakanobu and Nishino (2024), "Is an interest rate rise positive for households?"
Source: Made by MHRT based on data from the Ministry of Internal Affairs and Communications, Cabinet Office, and Bank of Japan.

4. Impact on corporations: increased interest payments reduce earnings with significant differences by scale and industry

(1) Interest rate hikes reduce corporate ordinary income by -1.3% due mainly to increased interest payments

Next, we consider the impact on corporate profits (ordinary income). In this report we estimate the impact of interest rate hikes on ordinary income in FY2024-2025 from two aspects: interest income and expense factors (direct effect of interest rate increases) and exchange rate fluctuation factors reflecting domestic and international economic trends (including domestic interest rate increases).

Regarding interest income and expense factors, the relative increase in debt interest rates compared to asset returns due to interest rate hikes[3] results in the negative impact of increased interest payments outweighing the positive impact of interest income (**Chart 6**). The impact of interest income and expense factors on ordinary income is estimated to be -1.1% over two years (2024-2025), indicating that interest rate hikes will reduce corporate ordinary income.

As for exchange rate fluctuation factors, as shown in **Chart 1,** gradual appreciation of the yen (FY2023: 144.0 JPY/USD to FY2025: 141.4 JPY/USD) is assumed. In this case, the negative impact of reduced exports due to the yen's appreciation will slightly outweigh the positive impact of lower import costs, resulting in a minor negative impact of -0.2% on ordinary income over two years.

Overall, the impact of interest rate hikes on ordinary income is estimated to result in a -1.3% decrease over two years (FY2024-2025). It should be noted that our estimate only considers the impact of interest rate hikes and associated exchange rate fluctuations, and if we factor in the gradual economic expansion presumed in the interest rate hike scenario, the impact on ordinary income will be slightly positive. For a detailed forecast of corporate profits considering the increase in revenue and personnel costs driven by economic expansion and other factors, refer to Mizuho Research & Technologies (2024).

(2) Small and medium-sized enterprises experience larger profit declines, widening the gap between large and small firms

The overall impact of interest rate hikes in FY2024 and 2025 on corporate profits will be negative, but the degree of impact will vary significantly by corporate scale. Looking at companies' balance sheets, large corporations tend to hold more interest-earning assets,

[3] For the relationship between interest rates (long-term interest rates) and corporate debt interest rates and asset returns, please refer to Hattori and Arita (2024), Chapter 3, Section 1.

while small and medium-sized enterprises (SMEs) tend to have relatively more interest-bearing liabilities. Consequently, large corporations will see a larger increase in interest income, resulting in a slight positive impact on interest income and expense factors, while SMEs will experience a larger increase in interest payments, leading to a significant negative impact (**Chart 7**). Although yen appreciation (exchange rate factors) will positively impact SME profits through lower import costs, the negative impact of increased interest payments will dominate, resulting in a -3.7% decline in ordinary income for SMEs compared to -0.4% for large corporations (large corporations will experience a negative impact from reduced exports due to the yen's appreciation).

Chart 6: Impact on corporate profits (corporate sector overall)

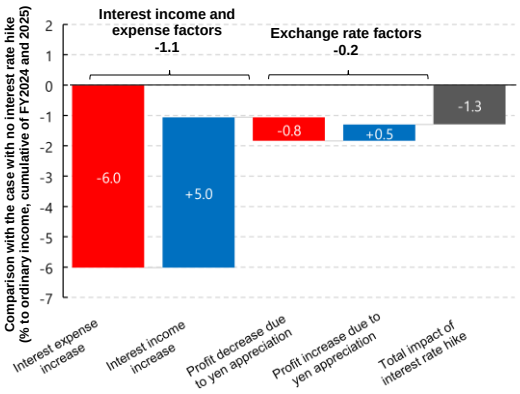
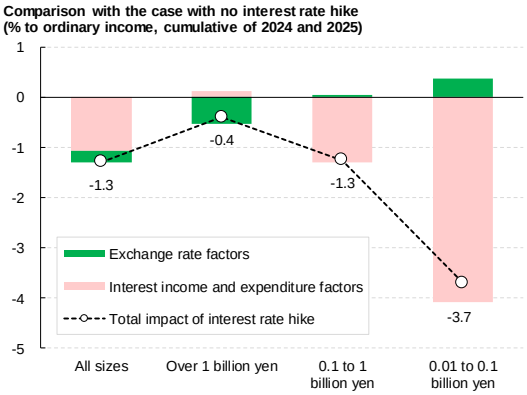


Chart 7: Impact on corporate profits (by capitalization size)



Note: Non-financial private corporations with capital of 10 million yen or more. Exchange rate fluctuation factors are based on an estimated 1.8% yen appreciation (144.5 yen to 141.4 yen).
Source: Made by MHRT based upon the Ministry of Finance, *Financial Statements Statistics of Corporations by Industry* (annual and quarterly surveys), the Cabinet Office, *The ESRI Short-Run Macroeconometric Model of the Japanese Economy (2022 version): Basic Structure, Multipliers, and Economic Policy Analyses* and *SNA Input-Output Tables*, the Ministry of Finance and Bank of Japan, *Direct Investment by Region and Industry*, and the Ministry of Economy, Trade and Industry, *Basic Survey of Japanese Business Structure and Activities*.

Based on this scenario, while large corporations (such as listed companies) are expected to maintain stable ordinary income despite interest rate hikes, SMEs will see a significant decline in ordinary income, widening the profit gap between large and small firms. Some SMEs may face bankruptcy risks, increasing more than ever the importance of business revitalization and restructuring. Bankruptcy is part of the economic renewal process, and if management resources (labor, know-how, etc.) are transferred smoothly to highly productive firms, it will contribute to overall economic productivity growth. However, a rapid increase in bankruptcies could hinder labor mobility due to rising unemployment, and the deterioration in household income conditions may negatively impact the economy. "Orderly restructuring" of companies through restructuring and reorganization and M&As before they go bankrupt will be required for the corporate sector to effectively utilize its limited resources to generate high added value. For a detailed discussion on this point, see

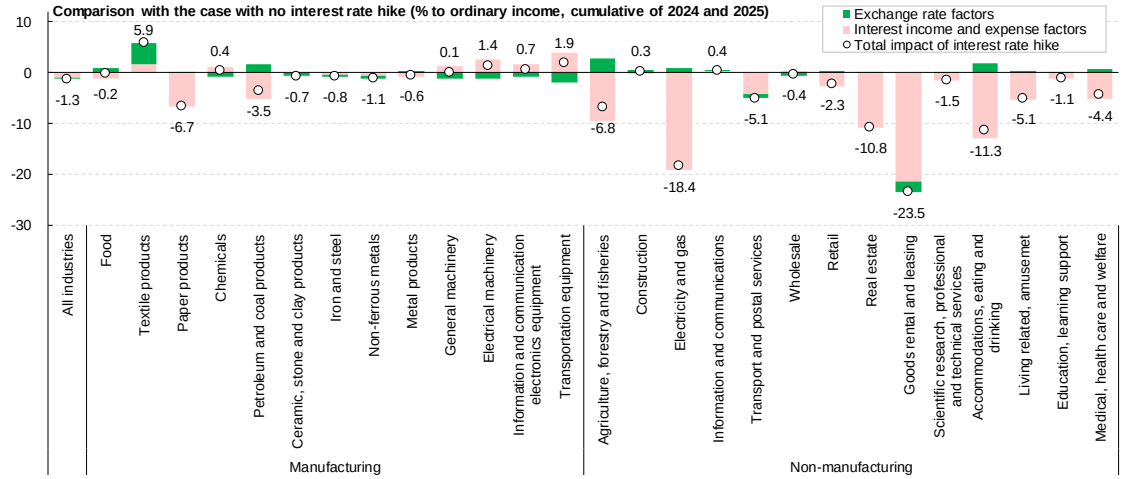
Hattori et al. (2024).

(3) Significant profit declines in industries with high interest-bearing liabilities, such as leasing, electricity and gas, and lodging and dining

The impact on ordinary income also varies significantly by industry. **Chart 8** shows the impact of interest rate hikes by industry (all company sizes total) for FY2024-2025. Industries such as leasing, electricity and gas, lodging and dining, real estate, agriculture, and paper products are expected to experience significant profit declines. These industries are characterized by having more interest-bearing liabilities than interest-earning assets, resulting in a larger increase in interest payments than interest income during rising interest rates.

Conversely, industries such as transportation equipment, electrical machinery, and general machinery are expected to see a positive impact on interest income and expenditure factors. These industries, especially large corporations, tend to hold more interest-earning assets, resulting in a larger increase in interest income than interest payments during interest rate hikes. Additionally, exchange rate fluctuation factors are expected to have a small positive impact on industries such as textile products, petroleum and coal products, agriculture, forestry and fishing, and lodging and dining. A slight appreciation of the yen against the US dollar through FY2025 will boost profits by lowering import costs for import-oriented industries.

Chart 8: Impact on corporate profits (by industry)



Note: Non-financial private corporations with capital of 10 million yen or more. Exchange rate fluctuation factors are based on an estimated 1.8% yen appreciation (144.5 yen to 141.4 yen).
Source: Made by MHRT based upon the Ministry of Finance, *Financial Statements Statistics of Corporations by Industry* (annual and quarterly surveys), the Cabinet Office, *The ESRI Short-Run Macroeconometric Model of the Japanese Economy (2022 version): Basic Structure, Multipliers, and Economic Policy Analyses* and *SNA Input-Output Tables*, the Ministry of Finance and Bank of Japan, *Direct Investment by Region and Industry*, and the Ministry of Economy, Trade and Industry, *Basic Survey of Japanese Business Structure and Activities*.

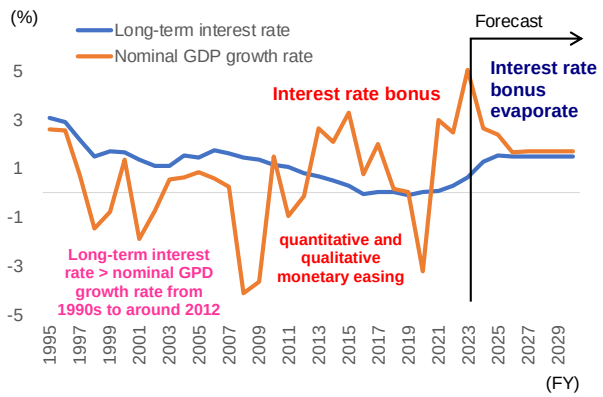
5. Impact on government (fiscal): "interest rate bonus" evaporates requiring a primary balance surplus

Next, we consider the impact on government (fiscal). As Sakai (2024a) points out, in a "world with interest rates," the impact on the government sector, the largest debtor, is concerning (with the debt-to-GDP ratio of the national and local governments around 212% as of FY2022, one of the highest levels globally). Until now, the Bank of Japan's monetary easing policy kept interest rates low even as the government's primary balance (PB) deficit continued to grow, so while the outstanding balance of public debt increased, rising government bond costs were suppressed (with the government enjoying an "interest rate bonus"). However, a rise in long-term rates to the mid-1% range will see the "interest rate bonus" evaporate (**Chart 9**).

If Japan transitions from a "world without interest rates"—where short-term rates are negative and long-term rates are zero—to a "world with interest rates"—where short-term rates are 0.5% and long-term rates are around 1.5% after FY2025—mechanical estimates suggest that national interest payments would increase by over 13 trillion yen by FY2033 (**Chart 10**). The average maturity of government bonds was approximately 9 years and 5 months as of the end of FY2023, meaning that interest rate hikes will not immediately lead to increased interest payments. Therefore, while the impact of rising interest rates will be suppressed in the short term, interest payments will gradually rise with increasing pressure on fiscal management.

In recent years, tax revenues have increased with the expansion of nominal GDP. However, in Japan, where the potential growth rate is low and high growth is hard to foresee, it is difficult to envision a high growth scenario where growth rates consistently exceed interest rates. As shown in **Chart 9**, the medium-term nominal economic growth rate will highly likely be in the mid to upper 1% range (assuming no acceleration in productivity growth), with little difference from long-term interest rates. In such a situation, if primary balance surpluses are not achieved due to the repeated supplementary budgets and an increase in social security costs, the government's debt-to-GDP ratio will continue to rise. Similar to Sakai (2024), assuming an increase in social

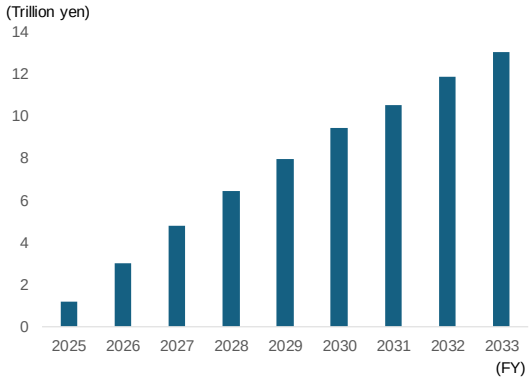
Chart 9: Long-term interest rates and nominal GDP growth rate



Source: Made by MHRT based on the Cabinet Office, LSEG, and other sources.

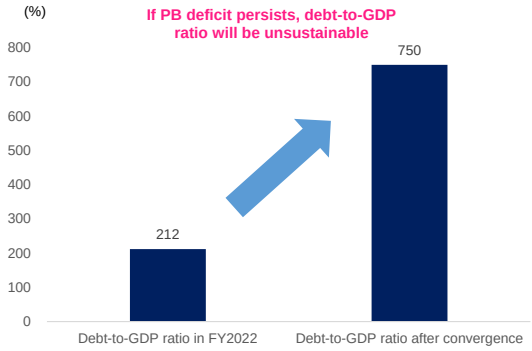
security costs due to the nation's aging population, if the PB-to-GDP ratio of the central government is assumed to be around -2.5%, and the PB-to-GDP ratio of the local government around +1%, resulting in a combined central and local PB-to-GDP ratio of around -1.5% on a medium-term basis (equivalent to a 50% reduction in the deficit in FY2024 in the Cabinet Office's medium- to long-term estimates), and if the nominal GDP growth rate is around 1.7% (in the upper 1% range) and long-term interest rates are around 1.5%, the long-term debt-to-GDP ratio of the central and local governments would rise to around 750%, a level likely to be perceived as "unsustainable" by the market (**Chart 11**).

Chart 10: Increase in interest payments if long-term rates rise by 1.5%



Note: Mechanically estimated based on materials from the Ministry of Finance's Fiscal System Committee (April 4, 2024). The chart illustrates the increase in interest payments compared to a scenario without interest rate hikes.
Source: Made by HRT based on data from the Ministry of Finance.

Chart 11: Debt-to-GDP ratio of national and local governments if PB deficit continues



Source: Made by MHRT based on the Cabinet Office, Ministry of Finance, and other sources.

As Sakai (2024a) notes, there is no clear economic consensus on what debt-to-GDP ratio constitutes "fiscal collapse." However, if government debt continues to increase rapidly relative to the economy, it may trigger market concerns about the government's fiscal discipline. If confidence in government bonds is lost, interest rates could spike, and the risk of Japanese government bonds being downgraded by international rating agencies would increase. We need to watch for any situation where confidence in the Japanese yen is lost, as it could trigger rapid yen depreciation and inflation, and significantly impact citizens' lives. (For more on this, see the Mizuho Economic Forum's second session, "A World with Interest Rates and Fiscal Sustainability."[4])

[4] Please refer to the video at https://www.mizuho-rt.co.jp/publication/e-forum/index.html, which includes a keynote explanation by Senior Economist Saisuke Sakai in the first part and a discussion with Shigeki Morinobu, Research Director at the Tokyo Foundation for Policy Research, in the second part.

As Sakai (2024b) points out, fiscal consolidation will face its greatest challenge as all members of the "baby boomer" generation turn 75 or older by 2025. On the same day as the Cabinet approved the Basic Policy on Economic and Fiscal Management and Reform 2024, which aims to achieve a PB surplus for the central and local governments by FY2025 (for the first time in three years), Prime Minister Fumio Kishida announced plans to formulate economic stimulus measures, indicating that political pressure to increase spending remains strong. This situation raises concerns about future fiscal management. Even if nominal economic growth is able to boost tax revenue, continued spending increases will not serve to improve the primary balance. Efforts are therefore needed to improve the primary balance and stabilize the debt-to-GDP ratio over the medium term, rather than linking tax revenue increases to increased spending.

6. Future monetary policy operations face high uncertainty: beware of the risk of higher-than-expected interest rate hikes

As discussed, various aspects of the impact on the Japanese economy if a "world with interest rates" arrives have been examined. Assuming the Bank of Japan raises interest rates to 0.5% and then adopts a wait-and-see approach, the overall macroeconomic impact of rising interest rates will not be significant. However, substantial negative impacts are anticipated for entities with significant debt. Given the slow pace of economic recovery, particularly in personal consumption, and the high political hurdles for rate hikes, the Bank of Japan is expected to proceed cautiously with rate hikes, keeping these negative impacts in mind (we believe rate hikes are unlikely to be implemented to correct the yen's depreciation).

That said, there is significant uncertainty regarding wage, price, and monetary policy trends. Referring to the analytical framework of Osada and Nakazawa (2024), if we calculate the "composite index of inflation expectations" using household, corporate, and expert inflation forecasts, the outcome is an increase of 1.6% for the April to June quarter of 2024 (**Chart 12**), and as Kawata (2024) points out, since the likelihood of an immediate breakdown of "the prospect of achieving the 2% price target" is also declining, there is a realistic scenario where the policy rate could be raised to around 1%.

Furthermore, if sustained wage and price increases continue due to changes in corporate wage and pricing behaviors (norms) (a case where the rate of wage increase after 2025 is in the mid to upper 4% range), the neutral interest rate could rise significantly by FY2026-27. This would create room for further rate hikes, and the Bank of Japan could raise the policy rate to over 2%. In that case, long-term interest rates may exceed 2%, and the impact on various sectors would be closer to the results of the studies by Miyazaki et al. (2023), Nakanobu and Nishino (2024), Hattori et al. (2023), and Sakai (2024). While sustained price and wage increases would boost corporate performance and household income, the negative impact on debt-holding sectors would be even greater than the estimates in this report. For households, the burden would increase for low- to middle-income and younger households with high mortgage debt and few financial assets, while corporate profits would be squeezed, particularly in industries with high interest-bearing liabilities, exacerbating the polarization within the corporate sector. For the government sector, fiscal management would need to maintain a PB surplus sufficient to cover the gap between interest rates and growth rates to prevent the debt-to-GDP ratio from rising.[5] Preparations should be made with the awareness that interest rate increases beyond the 0.5% assumed in this report could materialize, particularly for those sectors holding significant debt.

Chart 12: Composite index of inflation expectations (10 years ahead)

Note: For details on the calculation method, see Osada and Nakazawa (2024). Created using household (Opinion Survey on the General Public's Views and Behavior, quantitative and qualitative questions), corporate (Tankan), and expert (Consensus Forecasts, QUICK survey, inflation swaps) inflation expectations. Data before 2006 are reference values. Data up to 2024/1Q are the same as those in Osada and Nakazawa (2024). Data for 2024/2Q are estimated by the author.

Source: Osada and Nakazawa (2024), Bank of Japan, Bloomberg, QUICK Monthly Survey <Bonds>, and Consensus Economics, *Consensus Forecasts*.

[5] Sakai (2024b) estimates that if the nominal growth rate hovers around 1.5% and long-term interest rates around 2%, maintaining the central and local government debt-to-GDP ratio at the current level (approximately 212% in FY2022) would require a primary balance surplus of about 1% of GDP for both central and local governments. Looking ahead to rising interest rates, it is essential to recognize that achieving a primary balance surplus is merely a milestone; the crucial point is fiscal balance control, including interest payments.

Reference

Refer to the original Japanese report by clicking the URL below for the reference material.
https://www.mizuho-rt.co.jp/publication/report/2024/pdf/insight-jp240725.pdf