Is the Japanese Economy Prepared for Higher Interest Rates?

Upward pressure on long-term interest rates is intensifying. At the time of the exit from the negative interest-rate policy this March, the yield on 10-year Japanese government bonds remained at 0.7–0.8% without much fluctuations, but it surpassed the major benchmark of 1% on May 22 and rose above 1.1% at one point on May 30, posting the highest level since monetary easing of a different dimension was initiated in April 2013. The background to this was the growing perception in mid-to-late May that government bond purchases by the Bank of Japan (BOJ) would shrink and that the central bank may raise the policy interest rate sooner than expected. Rumors that the BOJ may act to check the devaluation of the yen, which advanced at one point to the 160 yen per dollar level, also gave momentum to the rise in interest rates.

Many economists predict that because disposable income will be supported by favorable base pay increases in this year's *shunto* spring wage negotiations and these will be combined with income tax reductions by the Kishida administration, the economy will turn to consumption-driven positive growth in the April–June quarter. And this viewpoint is partly boosting the sentiment that interest rates would rise in the future. In fact, looking at the policy interest rate projections (uncollateralized overnight call rate) in the ESP Forecast Survey (May) by Japan Center for Economic Research the largest number of responses were for 0.2–0.3% at the end of this year and 0.7–0.8% at the end of next year. The expectations are that the policy interest rate will be raised by 0.7 percentage points over the next roughly year and a half, and that long-term rates will rise in line with that.

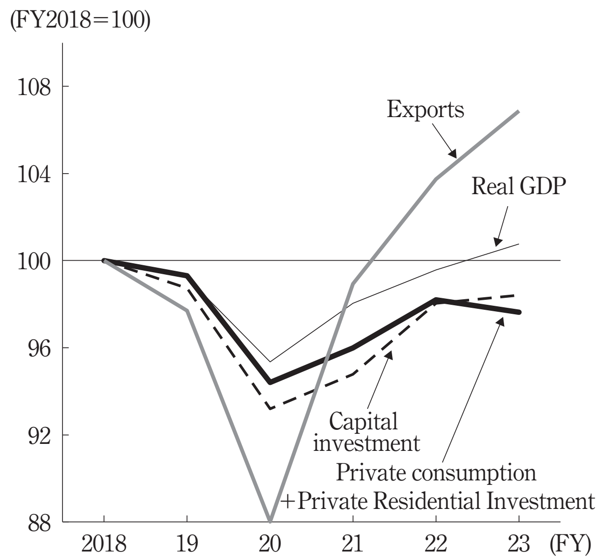
Before considering the impact of such higher interest rates, we first confirmed the status of the recovery of the Japanese economy tracing the transition in real GDP since fiscal 2018, prior to the Covid-19 pandemic, with the fiscal 2018 level set as 100. According to this, while the overall level of real GDP reached 100.7 in fiscal 2023, slightly surpassing the fiscal 2018 level, the total of private consumption and private residential investment, which are the main components of domestic demand, was at 97.6, and capital investment was at 98.6, both below the fiscal 2018 levels (see Figure 1). On the other hand, exports were up sharply at 106.8, clearly indicating that the Japanese economy was supported by overseas demand during this period. Noting this point and the fact that private consumption was down quarter-to-quarter in the four consecutive quarters through the January–March quarter this year, it is probably more appropriate to conclude that the recovery of domestic demand since the pandemic is still far from sufficient and that the growth potential of the Japanese economy remains feeble.

Then, are companies and households prepared for the increase in interest rates? According to the *Financial Statements Statistics of Corporations by Industry*, the ratio of net interest-bearing debts (calculated by dividing [interest-bearing debts minus liquidity on-hand] by equity capital), which was 38.3% at the end of March 2019, rose beyond 42% at one point with the Covid-19 pandemic, but dropped back to 37.8% in the most recent figures at the end of March 2024. That is lower than the level at the end of March 2013 (51.2%) before monetary easing of a different dimension was initiated and it suggests that with the improvement in corporate financial health, companies have a stronger ability to withstand interest rate increases. For that reason, according to the BOJ's *Survey regarding Corporate Behavior since the Mid-1990s* (released in May), approximately 70% of companies now think that it is desirable for prices and wages to rise gradually in tandem. This finding is linked to the belief that a suitable rise in interest rates is acceptable.

In contrast, there is a growing trend whereby households are taking a negative view of price rises. For example, according to the *Consumer Confidence Survey* released on May 29, the Consumer Confidence Index (Households of two or more persons), which shows consumer sentiment, declined month-on-month for two consecutive months in April and May (see Figure 2) and the basic assessment was revised downward to "improvement is at a standstill." Looking at the breakdown of the index, the decline in the willingness to buy durable goods stands out. In short, the inclination to delay major purchases is growing stronger. If interest rates are increased while the fundamental tone of consumption is weak, this may have a considerable impact on consumers who use loans and have insufficient savings.

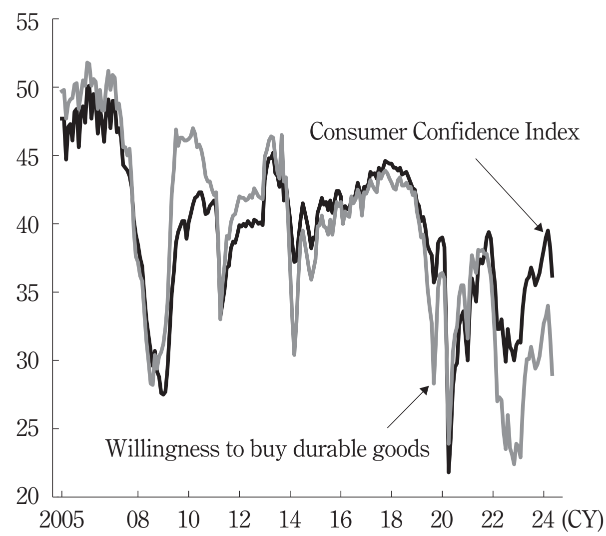
Considering this, when the BOJ aims toward normalization from its ultra-easy monetary policy, the timing of interest rate hikes must be carefully considered so that these do not have a severe impact on the Japanese economy, which is not all that strong, especially in the household sector. It would be putting the cart before the horse if hasty rate hikes urged by the market stall the economy and widen disparities.

Figure 1: Real GDP Trend by Item



Source: *National Accounts of Japan* by Cabinet Office

Figure 2: Transition of the Consumer Confidence Index



Source: *Consumer Confidence Survey* by Cabinet Office