



How much do rate hikes affect the real economy?

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I am not a macroeconomics expert, but whenever I listen to debates on monetary policy I question whether interest rate hikes in Japan today would meaningfully affect the real economy or significantly ease inflationary pressures. My sense is that they would not.

Limited sensitivity to higher rates

Starting with the corporate sector, most Japanese companies that are actively investing and expanding today are already well capitalised. For these firms, modest rate hikes are unlikely to alter investment behaviour in any meaningful way. Companies that have been kept alive primarily through bank support may be forced to adjust their strategies, but this is unlikely to have broader economic implications.

The same is largely true for households. Aside from mortgages, relatively few households rely heavily on borrowing, suggesting that the direct impact of higher interest rates on consumption would be modest. Moreover, given Japan's ageing demographics, even a moderate increase in rates would still leave overall interest levels low by historical standards, offering little incentive for households to raise savings materially. In fact, among wealthier elderly households, higher interest income could even support consumption rather than suppress it.

Equities able to absorb rate increases

Likewise, for the stock market, provided rate hikes do not coincide with other negative shocks, the impact should be limited. Pressure on companies to improve ROE remains strong, and both investors and companies are increasingly viewing the 8% figure cited in the 2014 Ito Report, compiled by the Ministry of Economy, Trade and Industry, as merely a baseline. As a result, the equity spread would remain ample even if the policy rate were to rise to 1–2%.

First-time buyers pay the price

The segment of the real economy most sensitive to interest rates is the housing market, particularly first-time buyers. In Japan today, aside from city-centre high-rise apartments, houses are generally not regarded as

appreciating assets. For most people, the decision to buy a home tends to depend on a comparison between current rent payments and the mortgage repayments they would face after purchase. With upward pressure on rents remaining subdued outside city centres and certain popular areas, rising interest rates become a direct disincentive to home purchases.

As variable-rate mortgages are prevalent, this would particularly affect those who have recently bought a home. In many cases, mortgage contracts are structured so that monthly payments do not increase immediately, but the negative impact on household consumption is still likely to emerge before long.

That said, demand for luxury city-centre high-rise condominiums is unlikely to be materially affected by short-term fluctuations in interest rates, unless these coincide with other adverse factors. Buyers in this segment tend to be either wealthy individuals or foreign investors, and purchasing decisions are driven largely by expectations of long-term capital appreciation.

Gradual pressure on Japanese public finance

Another entity highly sensitive to higher interest rates is, needless to say, the Japanese government, given its substantial debt burden. However, since most government bonds have been issued at long term fixed rates, fluctuations in short term policy rates have only a limited effect on debt servicing costs.

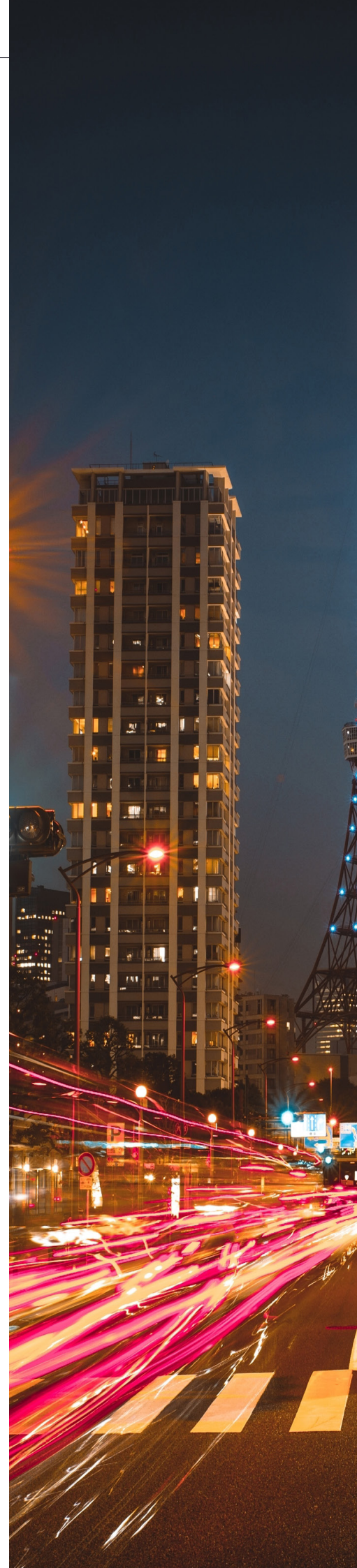
That said, market yields on government bonds have already begun to rise, and fiscal management is likely to become steadily more challenging over time, even in the absence of further rate hikes.

The only immediate transmission channel: the yen

In summary, while rate hikes are unlikely to exert a strong or immediate direct impact on the real economy, there is one channel through which they could have a significant effect: appreciation of the weak yen.

We view the current exchange rate as borderline insulting to Japanese workers, and it is undeniable that Japan's low interest rates have been one contributing factor.

Even so, there is no guarantee that modest rate hikes would meaningfully correct the yen's weakness. In any case, exchange-rate levels should not be regarded as the primary objective of monetary policy.



Why rate hikes are a weak tool against inflation

In summary, if there is not a correction of the weak yen, rate hikes would mainly suppress the housing sector and redistribute income from existing homeowners to depositors and banks, without easing inflationary pressures. While I would benefit from higher interest rates, provided the stock market does not decline, we find it difficult to agree with the view that raising interest rates is an obvious solution to inflation.

So, what are the real sources of inflationary pressure?

I believe the true drivers of inflation in Japan lie elsewhere: a shrinking labour force, supply constraints caused by global division, overinvestment in certain industries, and the accumulation of financial assets in the private sector as a legacy of past fiscal deficits. One could argue that fiscal stimulus targeting growth over the years did not immediately translate into immediate results as savings in the private sector, but rather that demand is materialising with a time lag of several years, if not decades. From the perspective of households and corporations, this is their own money, and of course monetary policy does not have an effect.

In the end, the only viable path to begin to substantively reduce inflationary pressures, is a sustained effort to rein in fiscal deficits.

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