ECONOMIC NEWS JOURNAL

21/12/2025

Kim Dowon, dowonjn.k@gmail.com, BSocSc (Hons) in Global Economics and Banking, Lingnan University

BANK OF JAPAN RAISES POLICY INTEREST RATE

NEWS SUMMARY

The Bank of Japan raised its interest rate to the highest in 30 years in its December 2025 meeting following an initial hike in January 2025. The hike was an increase of 0.25 percentage points, raising the policy rate to 0.75% from 0.5%. The unanimous decision was made as the BOJ grew in confidence that inflation and wage growth could be sustained around the 2% target. They also pointed to data that showed solid wage growth momentum and subsiding risks from US tariffs.

MARKET REACTION: YEN AND BONDS

Governor Ueda suggested that the pace of any further rate hikes would depend on how the economy responds to each policy change and asserted that they would continue raising borrowing costs if economic outlook is realized.

However, after Ueda spoke, the yen weakened to 157.7 against the dollar, suggesting that traders put an emphasis on the BOJ's cautious guidance, rather than the 25 basis point move. This shows that expectations for USD/JPY weigh heavier on Japanese and US interest rates than a single 25 basis point hike. The yen was trading around 155 before the decision.

Furthermore, the rate hike pushed the 10-year yield to around 2%. As investors demanded higher returns to hold longer-term debt, the 10-year yield reached levels seen for the first time in two decades. As bond prices move inversely to yields, this meant that bondholders saw the value of their holdings fall when the BOJ signaled a willingness to continue normalizing policy.

CARRY TRADE

For years, Japan's near-zero interest rates made the yen an extremely attractive funding currency for a carry trade: where investors borrowed cheaply in yen and invested in higher-yielding assets overseas. While the rate hike does not immediately kill the carry trade, it narrows the rate gap with other economies and raises the cost of funding, making leveraged positions less attractive. With the US Federal Reserve lowering their target range to 3.5%, and signaling further easing, the interest-rate gap with Japan is expected to narrow, which would gradually make the yen carry trade less attractive.

Additionally, as the 10-year yield pushes past 2%, it influences hedging costs, repatriation incentives, and the attractiveness of the carry trade. The yen is weakening against the dollar, however, it signals that the market believes that the rate gap is still large enough to continue with the yen carry trade.

HOUSEHOLDS AND FIRMS IN JAPAN

In the broader Japanese economy, the BOJ saw that it was highly likely both wages and prices would rise together and would be maintained, with firms expected to continue increasing pay into 2026. Inflation had been over the 2% target for many months, but real wages continued to fall. Therefore, the hike was utilized to anchor inflation expectations. Over time, this would reward savers more and would help anchor inflation closer to the target if wage growth was to continue, ultimately supporting stability in consumption and investment.

Furthermore, Mizuho research on a 0.25 percentage point hike estimates that households, in aggregate, see a net gain of ~0.6 trillion yen due to higher deposit interest income. This would outweigh the mortgage interest burden of about 0.4 trillion yen. However, indebted households would face higher repayments, whereas cash-rich households would benefit from higher returns on deposits and government bonds. This implies that gradual hikes can benefit net-saver households overall, even though indebted families would face higher repayments.

For firms, the hike increases borrowing costs, which could weigh on leveraged companies and capex plans, given Japan's soft growth and recent GDP contraction. At the same time, the normalization of policy could support healthier bank margins and an efficient allocation of credit.