

# The Term Structure of Cancellable Lease Rates<sup>#</sup>

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Miki Seko<sup>\*</sup>

Kazuto Sumita<sup>\*\*</sup>

Jiro Yoshida<sup>\*\*\*</sup>

We develop a no-arbitrage pricing model for cancellable leases to study the term structure of lease rates. Our model demonstrates that cancellable lease rates always exhibit an upward-sloping term structure in a frictionless economy. When we introduce leasing frictions such as vacancies arising from market illiquidity, a partially downward-sloping structure can be obtained. Our residential lease sample in Japan exhibits a downward-sloping term structure up to approximately six years, and open-ended lease rates lie between the one-year and six-year rates. This empirical term structure is consistent with our calibrated model that incorporates large market frictions. (*JEL*: G12, G13, R31)

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<sup>\*</sup> Faculty of Political Science and Economics, Musashino University, 3-3-3 Ariake, Koto-ku, Tokyo, 135-8181, Japan.  
Email: seko@econ.keio.ac.jp.

<sup>\*\*</sup> Faculty of Economics, Toyo University, 5-28-20, Hakusan, Bunkyo-ku, Tokyo 112-8606, Japan.  
Email: sumita@toyo.jp.

<sup>\*\*\*</sup> Corresponding author. Smeal College of Business, The Pennsylvania State University, 368 Business Bldg., University Park, PA 16802, USA. Phone: 814-865-0392. Fax: 814-865-6284. Email: jiro@psu.edu.