AT A GLANCE | Japan

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Conditions for a Virtuous Cycle

Economist: Tetsuya Sano

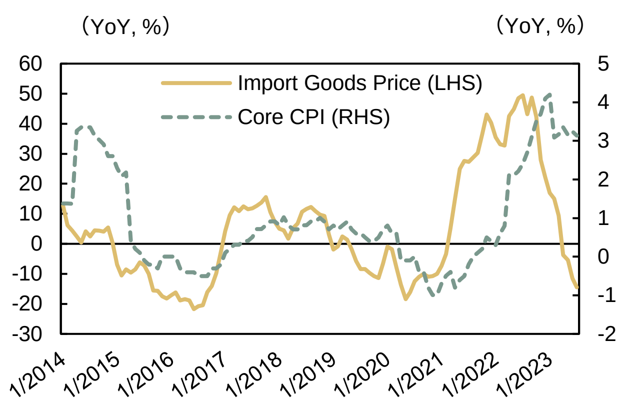
The Bank of Japan (BOJ) and some its prominent economists support maintaining large-scale monetary easing until wages rise. In this regard, many readers may be uncomfortable with the idea of using wages—the indicator that lags behind the economy the most—as a guideline for the conduct of monetary policy, a policy that requires a considerable lead time to affect the economy. However, if we examine the conditions necessary for a sustained rise in prices, it must be said that in order for the price-increase mechanism to continue to circulate in Japan, wages remain the last remaining issue to be overcome, as the Bank of Japan points out. It should also be noted that it is not necessarily wage trends themselves that are important in determining whether the price-rise mechanism has started to rotate, and that there is a reasonable possibility that the BOJ will make policy decisions based on, for example, consumption trends.

Income and Wages in the Japanese Economy

More than two years later, global inflation, which began in 2021, has yet to subside sufficiently. U.S. and European monetary authorities, which had initially insisted in 2021 that price increases were temporary, have since retracted that view in the face of persistent inflationary pressures and shifted to rapid monetary tightening. Looking back at Japan, however, the Bank of Japan has decided to make minor adjustments to its yield curve control (YCC) policy, but as a whole, the Bank of Japan is still maintaining its strong stance of monetary easing.

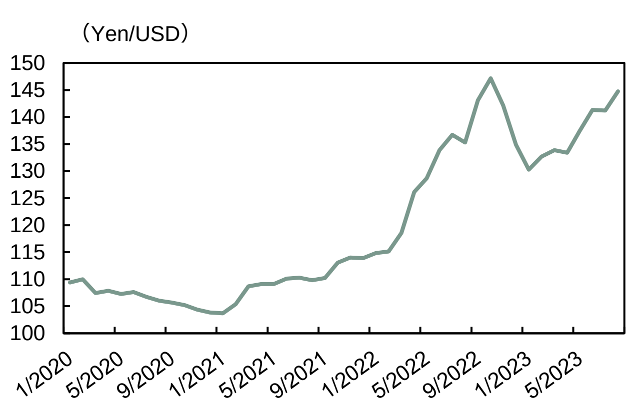
As it is now, the Bank of Japan’s stance has contributed to the rapid depreciation of the yen, which has led to concerns about the reluctance to lower import prices, which have started to decline year over year (Figures 1, 2). It is ironic that the Bank of Japan’s own actions are working to sustain import inflation, given that the central rationale for the temporary rise in prices is that “import inflation, the main cause of inflation, will eventually run its course.”

Figure 1: Import Inflation and CPI



Source: MIC

Figure 2: Exchange Rate

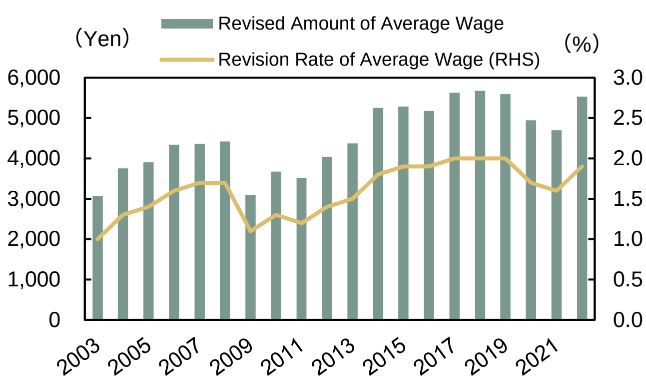


Source: BOJ

However, given that resource prices and the yen are not in a “blue” state (that is, import inflation does not rise indefinitely), the real issue, as the Bank of Japan points out, is whether higher prices due to cost-pushing will lead to higher wages. In this case, the bank’s view is summarized as “Will inflation persist due to factors that are endogenous to the Japanese economy rather than exogenous factors?”

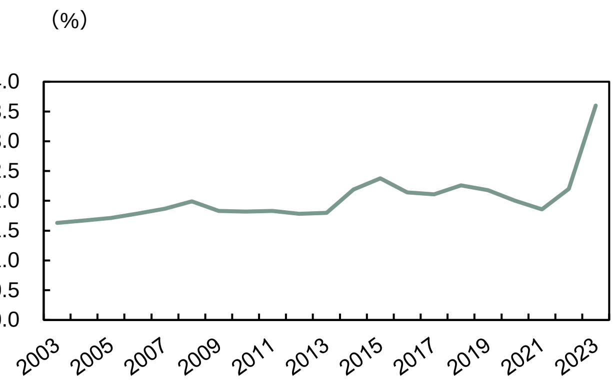
So why are wages the key to Japan’s endogenous price-growth mechanism? It is because, in Japan, wage inadequacy has become the most persistent pathology that hinders the rotation of the so-called wage-price spiral, a cyclical mechanism of price increases. The reality of prices in Japan is that the long-standing rigidity of (nominal) wages (Figure 3 shows a steady increase, with most of the increase in the fixed amount [1.5%]) has led to consumers’ deep-rooted “defensive” sense and a low tolerance for price increases, leading in turn to a zero-inflation equilibrium in which wages and prices are not matched.

Figure 3: Wage Revision Rate



Source: MHLW

Figure 4: Wage Growth Negotiated at *Shunto*



Source: MHLW

The Importance of Rising Wages in Japan’s Price-Increase Mechanism

More crucially, it is important to examine whether wages rise enough to meet household inflation expectations. To consider why this is the case, we would like to revisit the mechanism of sustained price increases.

First, it is essential that the bargaining power of workers be reasonably strong in order to realize wage increases. Specifically, the strength of workers’ bargaining power comes from (1) tight labor market conditions. However, no matter how tight the labor market becomes, companies will not raise wages sufficiently unless workers actively demand higher wages. The extent to which workers demand higher wages depends on (2) their inflation expectations.

As for companies, in order to accept workers’ demands for higher wages, companies must have the resources to do so. Funding requires (3) an increase in labor share or price shifting to increase earnings. The choice depends on households’ tolerance for price hikes and the competitive environment described below, but firms face real cost increases when wage increases exceed labor productivity growth, and thus are relatively more incentivized to pass these costs onto prices.

Even if the above steps are met and wages rise, there are still other conditions to be met if they are to lead to sustained price increases. Thus, consumers do not act in a defensive manner, that is, they do not act with excessive parsimony in the face of rising prices. In order to meet this condition, it is important that wages rise at least as much as the inflation rate expected by households, as mentioned above.

Figure 5: Price-Increase Mechanism and Specific Indicators

Price-Rise Mechanism	Specific Indicator
① Bargaining power of workers	Labor supply and demand (employment manpower assessment DI, job offer ratio, etc.)
② Demand for higher wages for workers	Personal inflation expectations
③ Financing of wage increases by companies	Labor share, price transfer, and corporate earnings
④ Consumer acceptance of price increases	Difference between the expected inflation rate and the wage increase rate

Source: SMBC

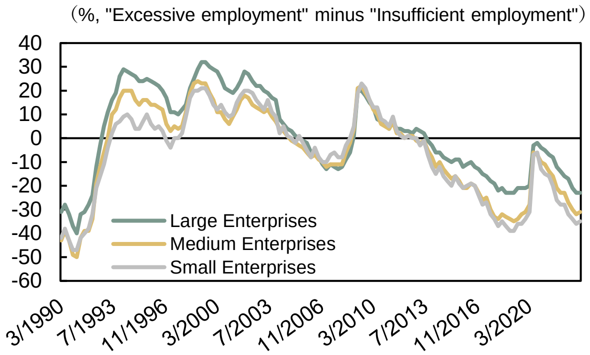
There may be some question as to why wages are expected to rise in Japan, while in Europe and the United States wage increases are viewed with more apprehension. However, the answer to this question is also simple based on the above mechanism. That is, the wariness of wage increases can vary depending on whether there is a risk that the anchor of the inflation rate expected by workers is off, whether workers have the power to raise wages based on the expected inflation rate that is off the anchor, and whether workers accept the resulting increase in prices.

Review of the Sustained Price-Increase Mechanism in Japan

Looking at historical developments in Japan, it has been difficult to say that the conditions necessary for a sustained increase in prices have been met (Figures 6, 7, 8, 9).

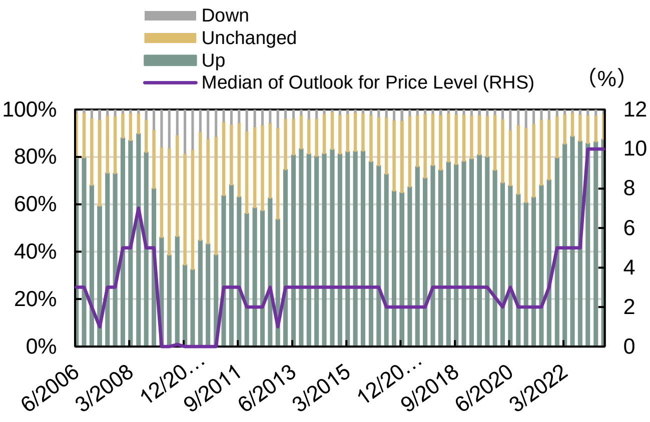
If we examine labor supply and demand, we note that the labor market had generally remained overstaffed until the first half of the 2010s, except just before the Lehman Brothers shock. Moreover, the expectation of falling prices among consumers (workers) has persisted and been maintained by a certain percentage of the population even after the Bank of Japan set an inflation target of 2%. Against this backdrop, the labor share has remained flat as a result of weak bargaining power among workers and modest demands for higher wages in favor of job protection. In addition, firms' ability to pass costs onto prices and expectations for passing costs onto prices remain weak, and consumers' strong sense of wishing to maintain their daily lives persisted, so their attitude of not allowing price increases was consistently strong. In short, all the conditions necessary to expect cyclical increases in wages and prices have not been met in Japan, and in fact, there have been no sustained price increases.

Figure 6: Employment Status DI



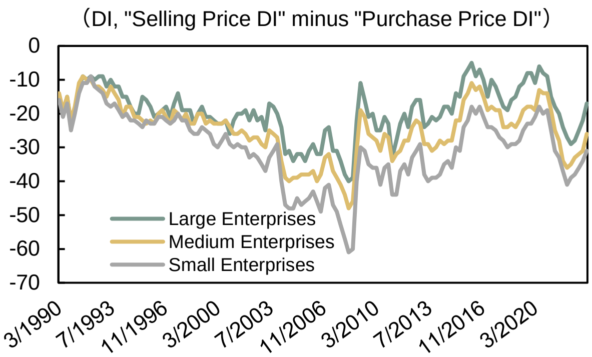
Source: BOJ

Figure 7: Consumer Price Outlook in One Year



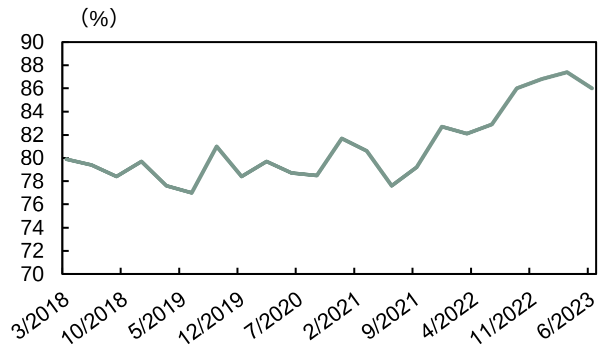
Source: BOJ

Figure 8: Price Passing Power of Firms



Source: BOJ

Figure 9: Awareness of Life Defense*



*Perception of inflation: "If anything, it's a problem."

Source: BOJ

How Is the Price-Growth Mechanism Changing?

But as we all know, Japan's frozen price-raising mechanism is finally showing signs of thawing. The initial heat source of thawing was import inflation, which directly worsened consumers' economic welfare, but that heat source is gradually loosening the frozen price-raising mechanism. In other words, there is a possibility that external heat may begin to re-rotate the sustained price-increase mechanism through wage increases.

Among the conditions already seen, consumer inflation expectations are rising on the back of real price increases. In addition, the level of wage increases, which are still insufficient but have not been seen in decades, is also increasing. Thus, the labor share has risen in recent years, forcing companies to consider price shifting more seriously than before in order to raise wages.

"There is a forward-looking pricing movement in which sales prices are raised in advance in anticipation of future increases in wage costs, etc.," Bank of Japan Governor Kazuo Ueda said in a speech this week, acknowledging signs of a change in firms' pricing behavior.[1] In addition, several members of the BOJ's

1 In his speech, Governor Ueda described the virtuous cycle of rising wages and prices under economic improvement as a "second force", and said the main scenario is to move from the "first force" to the "second force", a price-shifting movement of import inflation.

Policy Board have been commenting on the emergence of a virtuous cycle. For example, Naoki Tamura said at a meeting of the Financial and Economic Council at the end of August, “As shown in the results of the spring labor-management negotiations, there has been a change in the wage-setting behavior of companies, and a virtuous cycle of wages and prices is being observed, with wage increases and the shift of these wage increases to selling prices, as well as improvements in consumer sentiment due to wage increases.” The Bank of Japan, too, has begun to make announcements with an eye on the fact that the price-increase mechanism is starting to move. This is because it has certain expectations about the probability of sustaining a virtuous cycle.

At present, however, the scale of wage increases has not kept pace with the pace of price increases, and consumers appear to be becoming more defensive in their behavior. In order for the sustained cycle of price increases to rotate in the future, it will be important to (1) broaden the scope of wage increases, (2) increase the amount of wage increases, and (3) stabilize workers’ inflation expectations and reduce their defensive attitudes (i.e., raise the level of tolerance for price increases).

We Don’t Necessarily Have to Look at Actual Wages to Predict Wage Trends

It is also important to note that in order to confirm these probabilities, we do not necessarily have to wait until we can ascertain the trend of wage increases, for instance with the results of next year’s spring wage negotiations. BOJ Governor Ueda himself stated this at a recent press conference.

As we have already seen in this report, the cycle of wage increases is based on a combination of factors, and the final figure, which is a combination of the factors listed in Figure 5, is the rate of increase in nominal wages that appears as a result of the spring wage negotiations. In addition, there is no logical necessity to attach special importance to the results of the spring wage sessions, considering that the proportion of non-regular employment is still extremely high in Japan, the proportion of workers covered by these negotiations is low, and the impact of the tight labor market is thought to be greater in non-regular employment, which serves as a control valve for employment.

Given the recent improvement in labor-market conditions, the rise in consumer price sentiment, and the increase in attempts to pass costs onto prices as the labor share rises, the level of household acceptance of price increases will be particularly important in looking at the future price-growth cycle. This can be indirectly seen not only from surveys but also from trends in real consumption.

While imports, exports, and business fixed investment are also important in monitoring economic trends, in the context of the BOJ’s inflation target, we should pay particular attention to developments in consumer spending in order to confirm the continuation of endogenous price increases. Since the BOJ has been releasing information emphasizing wages, it seems as if confirmation of wage increases is a necessary condition. However, in the speech given by Governor Ueda this week, consumption trends were mentioned as a key point for the future, suggesting that the BOJ is paying attention to whether a virtuous cycle between wages and consumption will emerge among the mechanisms for price increases. If this is the case, there is a possibility that the BOJ will surprise us by revising its policy without waiting for the confirmation of wage increases once the data on a firm (real) consumption movement is released.

Economic Outlook: 2023-2024 Forecast

Figure 1: Forecasts for Economic Growth, Inflation, and Unemployment Rates

		2022			2023				2024				2021	2022	2023	2024
		Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
US	Real GDP	−0.6	2.7	2.6	2.2	2.1	2.5	1.2	0.6	1.0	1.2	1.7	5.9	2.1	2.1	1.2
	Inflation	5.2	5.2	5.1	4.8	4.6	4.0	3.6	3.0	2.7	2.6	2.5	3.3	5.0	4.2	2.7
	Unemployment	3.6	3.6	3.6	3.5	3.6	3.7	3.9	4.2	4.4	4.4	4.5	5.4	3.7	3.7	4.4
Euro Area	Real GDP	0.8	0.3	−0.1	0.1	0.1	0.0	0.1	0.2	0.3	0.3	0.4	5.6	3.4	0.5	0.8
	Inflation	8.0	9.3	10.0	8.0	6.2	5.1	3.2	3.3	3.2	3.0	2.8	2.6	8.4	5.6	3.1
	Unemployment	6.7	6.7	6.7	6.6	6.4	6.5	6.6	6.7	6.8	6.8	6.8	7.7	6.7	6.5	6.8
Japan	Real GDP	5.3	−1.2	0.2	3.2	4.8	0.9	0.8	0.9	0.9	1.1	1.1	2.2	1.0	1.5	1.0
	Inflation	2.1	2.7	3.8	3.5	3.2	2.9	2.5	2.9	2.8	2.5	2.1	−0.2	2.3	3.0	2.6
	Unemployment	2.6	2.5	2.5	2.6	2.5	2.4	2.4	2.3	2.3	2.3	2.3	2.8	2.6	2.4	2.3
China	Real GDP	0.4	3.9	2.9	4.5	6.3	4.4	4.8	3.7	4.1	4.6	5.0	8.4	3.0	5.0	4.4
	Inflation	2.2	2.8	1.8	1.3	0.2	0.0	0.6	1.1	1.5	1.8	2.0	0.8	1.7	0.5	1.6
	Unemployment	5.8	5.4	5.6	5.5	5.2	5.3	5.2	5.1	5.0	5.0	5.0	5.1	5.1	5.3	5.0

Real GDP growth is in QoQ annualized for U.S. and Japan, QoQ for euro area and YoY for China and India. Inflation rate is in YoY%. Inflation rate is YoY, % of core index (ex. fresh food) for Japan, YoY % of PCE deflator for U.S., and total YoY% for the rest.

Figure 2: Forecast for Rates

Interest rate		2022	2023				2024				2022	2023	2024
		Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
US	Policy rate	4.25 ~ 4.50	4.75 ~ 5.00	5.00 ~ 5.25	5.25 ~ 5.50	5.25 ~ 5.50	5.25 ~ 5.50	5.00 ~ 5.25	5.00 ~ 5.25	4.75 ~ 5.00	4.25 ~ 4.50	5.25 ~ 5.50	4.75 ~ 5.00
	2yr	4.43	4.03	4.90	5.00	5.00	5.00	4.75	4.75	4.75	4.43	5.00	4.75
	10yr	3.87	3.47	3.84	4.50	4.20	4.00	3.90	4.00	4.00	3.87	4.20	4.00
Germany	Policy rate	2.50	3.50	4.00	4.50	4.50	4.50	4.50	4.25	4.00	2.50	4.50	4.00
	Deposit rate	2.00	3.00	3.50	4.00	4.00	4.00	4.00	3.75	3.50	2.00	4.00	3.50
	2yr	2.50	2.68	3.20	3.20	3.00	2.80	2.60	2.40	2.30	2.50	3.00	2.30
	10yr	2.20	2.29	2.39	2.80	2.50	2.30	2.20	2.10	2.10	2.20	2.50	2.10
Japan	Policy rate	−0.10	−0.10	−0.10	−0.10	−0.10	−0.10	0.10	0.10	0.10	−0.10	−0.10	0.10
	2yr	0.04	−0.06	−0.07	0.06	0.15	0.20	0.30	0.30	0.30	0.04	0.15	0.30
	10yr	0.42	0.35	0.40	0.77	0.75	0.80	0.90	0.90	0.90	0.42	0.75	0.90
China	Policy rate	2.75	2.75	2.65	2.50	2.40	2.40	2.40	2.40	2.40	2.75	2.40	2.40
	2yr	2.39	2.41	2.11	2.20	2.10	2.18	2.25	2.35	2.45	2.39	2.10	2.45
	10yr	2.83	2.85	2.64	2.60	2.55	2.60	2.65	2.70	2.75	2.83	2.55	2.75

Figure 3: Forecast for FX and Oil Price

		2022	2023				2024				2022	2023	2024
		Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
USD/JPY	Range	130.58 ~ 151.95	127.23 ~ 137.91	130.64 ~ 145.07	137.25 ~ 149.71	133.00 ~ 147.00	131.00 ~ 145.00	126.00 ~ 140.00	128.00 ~ 142.00	128.00 ~ 142.00	113.47 ~ 151.95	127.23 ~ 149.71	126.00 ~ 145.00
	End of quarter	131.12	132.86	144.31	149.00	140.00	138.00	133.00	135.00	135.00	131.12	140.00	135.00
EUR/USD	Range	0.9633 ~ 1.0735	1.0806 ~ 1.1033	1.0635 ~ 1.1095	1.0488 ~ 1.1276	1.0200 ~ 1.1200	1.0100 ~ 1.1100	1.0000 ~ 1.1000	1.0100 ~ 1.1100	1.0100 ~ 1.1100	0.9536 ~ 1.1495	1.0200 ~ 1.1276	1.0000 ~ 1.1100
	End of quarter	1.0705	1.0839	1.0909	1.0550	1.0600	1.0500	1.0500	1.0600	1.0600	1.0705	1.0600	1.0600
EUR/JPY	Range	138.81 ~ 148.40	124.40 ~ 145.67	142.55 ~ 158.00	151.42 ~ 159.76	144.00 ~ 158.00	138.00 ~ 152.00	133.00 ~ 147.00	136.00 ~ 150.00	136.00 ~ 150.00	124.40 ~ 150.00	137.39 ~ 159.76	133.00 ~ 152.00
	End of quarter	140.41	144.01	157.43	157.20	148.40	144.90	139.65	143.10	143.10	140.41	148.40	143.10
Crude Oil Prices (WTI)		82.64	75.99	73.67	82.23	82.00	82.00	76.00	77.00	78.00	98.74	78.47	78.25

※ Crude oil prices are averages for each period. Source: SMBC.

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