Political economy of inflation in Japan
- since the Ukraine War

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10 July (Sun)

House of Councilors (upper house) election

(6-years-term. Election is held every 3 years for half of the members.)

Japanese inflation in May:

<u>2.1% (Core CPI, excluding fresh food)</u>

2.5% (all)
0.8% (Core-core, excluding fresh food and energy)

[Political economy of inflation in Japan] (30 min)

(1) Background information: GDP growth, wages, prices, and currency

(2) Vicious circle of deflation

(3) Legacy of anti-deflation: Quantitative and Qualitative Monetary Easing (QQE)

(4) Recent development: food & energy crisis from the Ukraine War

(5) Policy measures on cost of living

(6) Linkage to public pension system

(7) Summary & Remaining questions

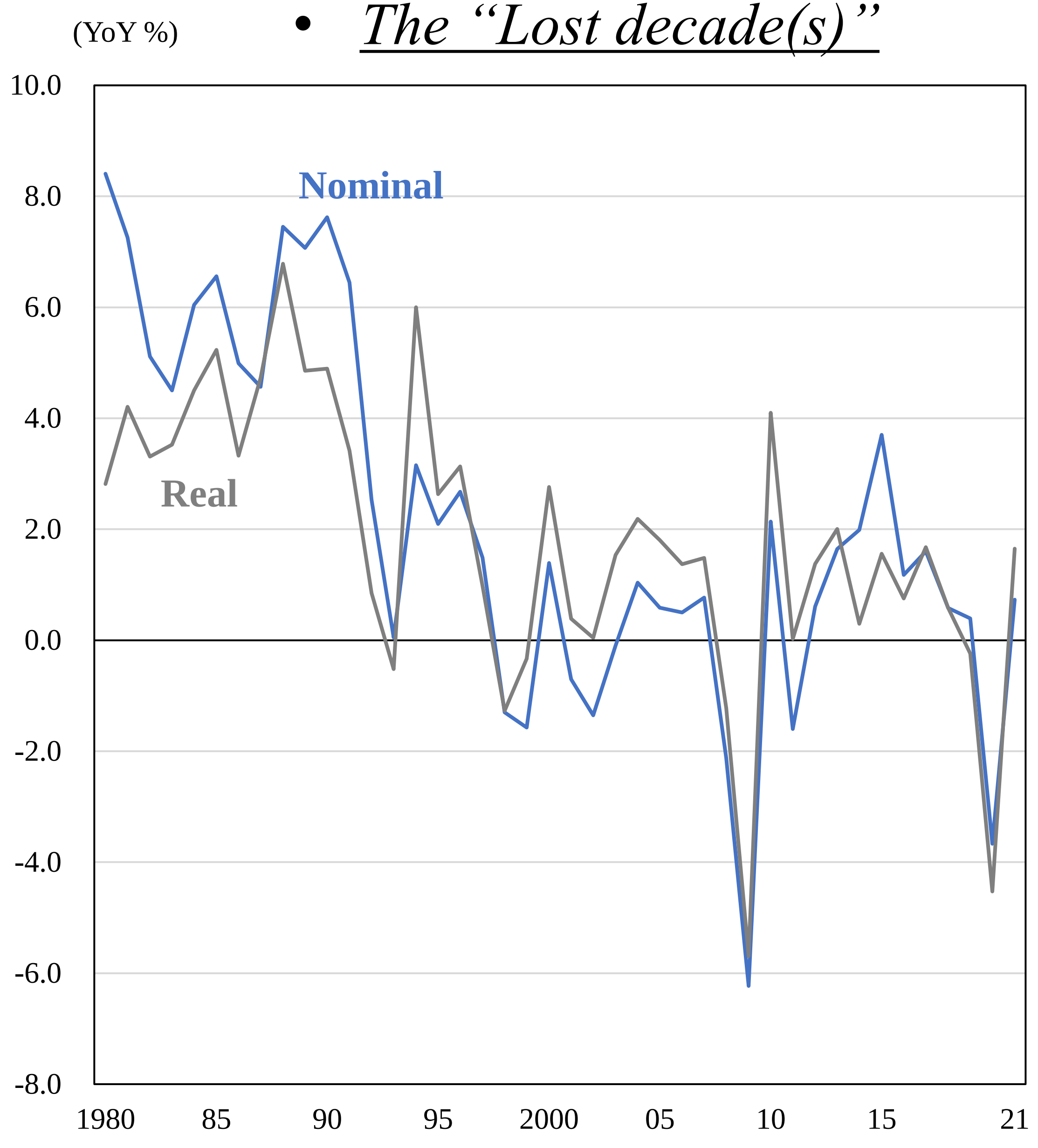
- -

[Chatham House events related to the Ukraine War] (5 min)

(1) Background information: GDP growth, wages, prices, and currency

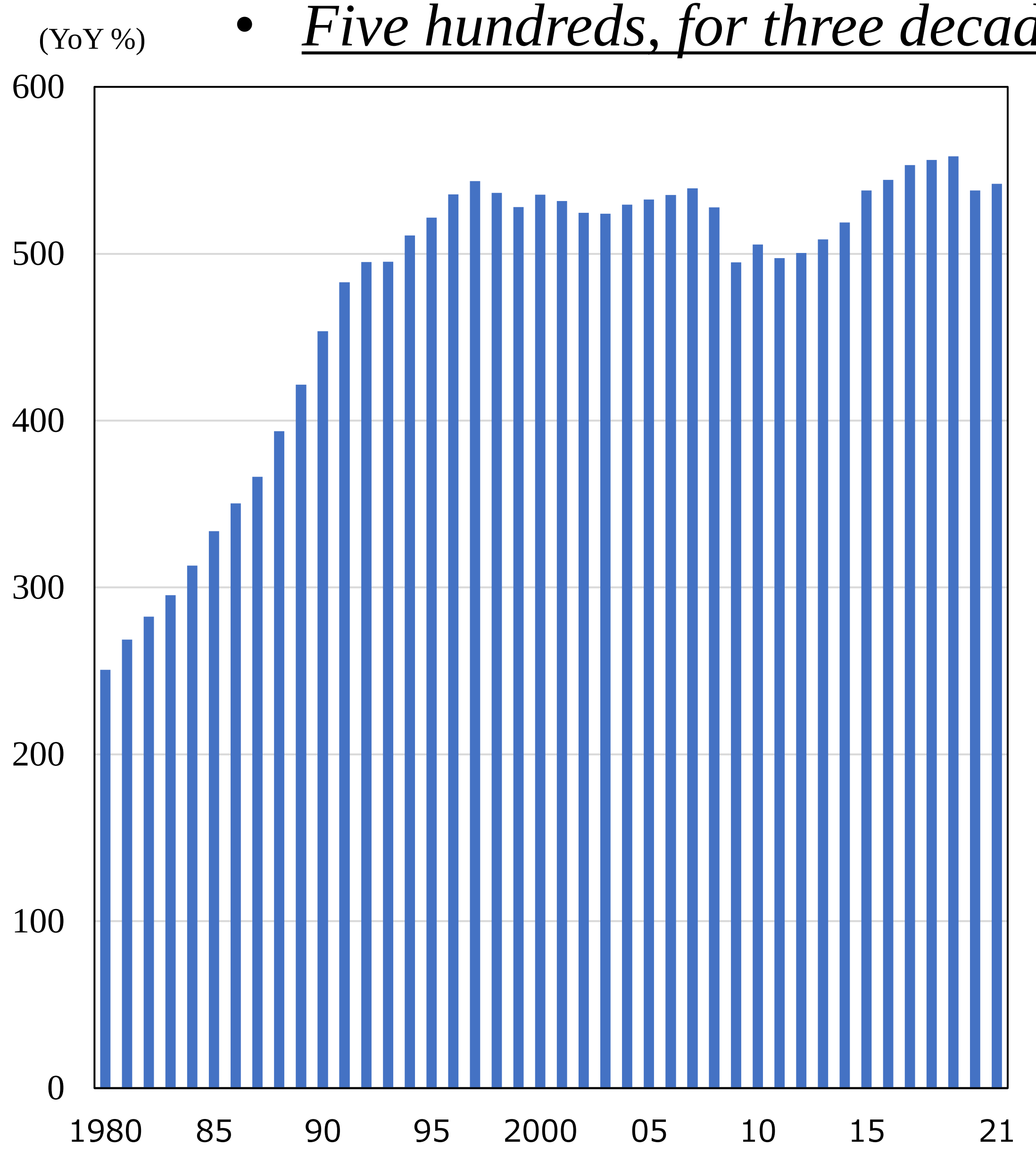
GDP growth rate

- *The "Lost decade(s)"*



Nominal GDP

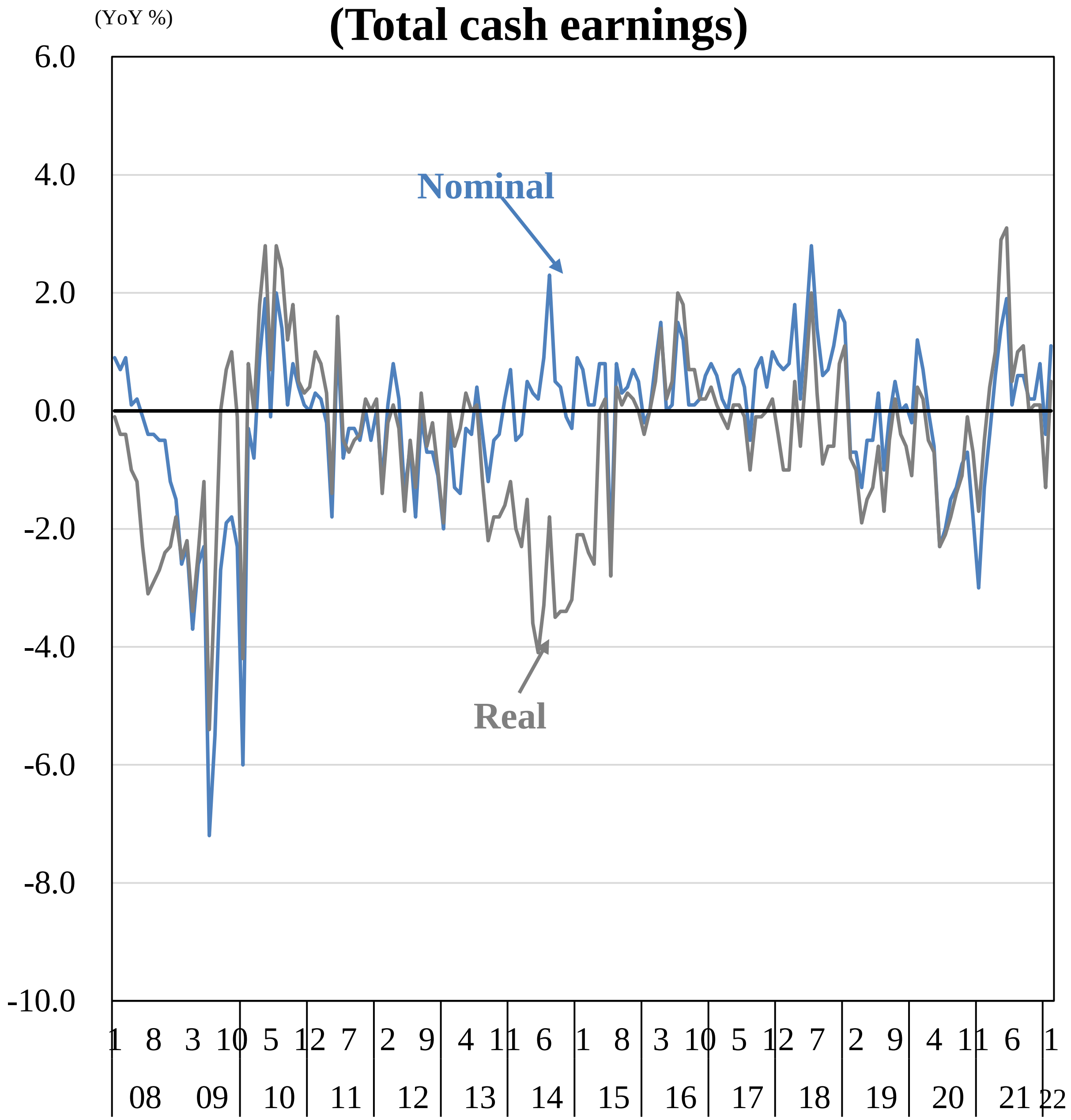
- *Five hundreds, for three decades*



(Source) Cabinet Office

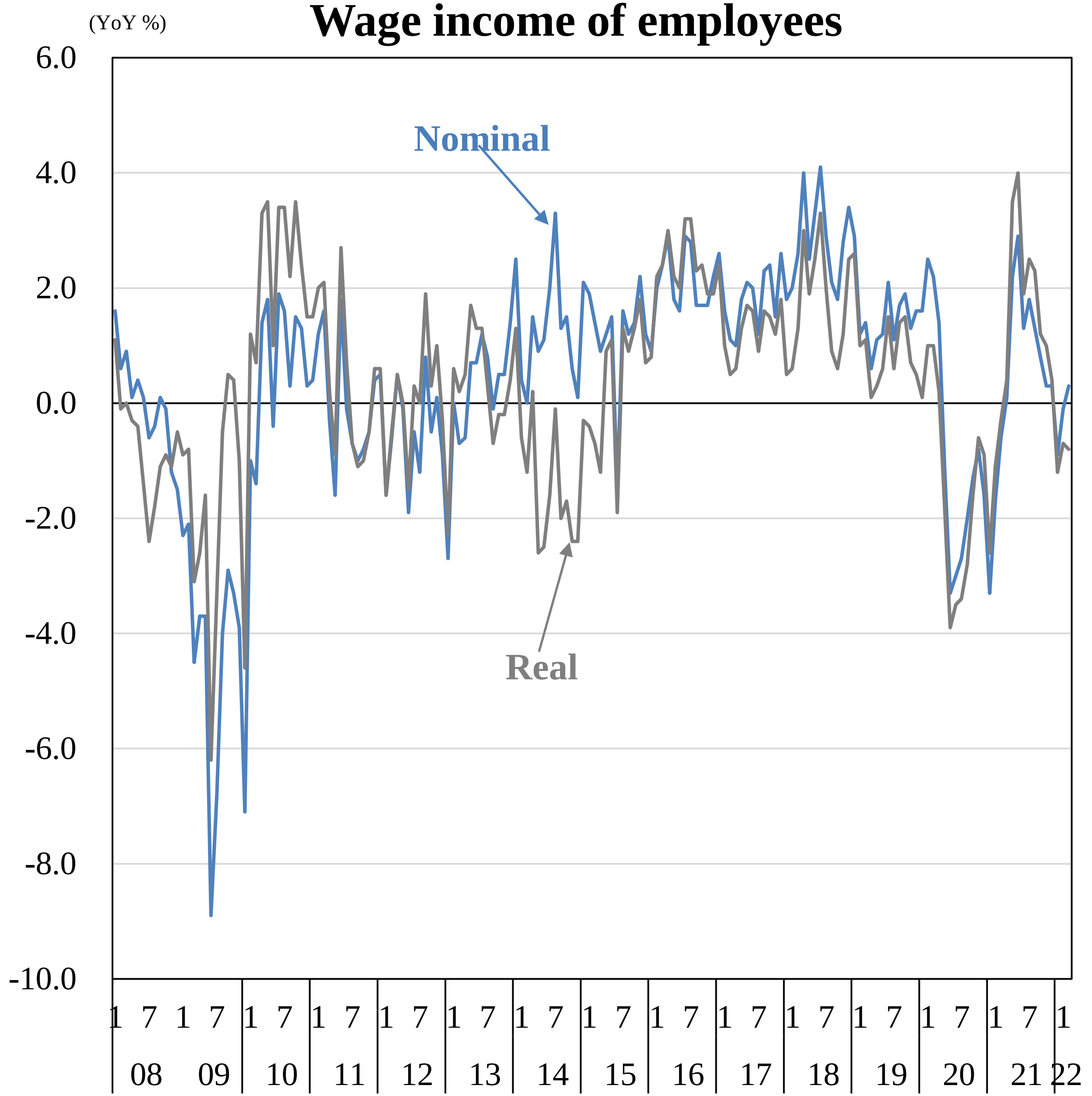
- *Low growth, low inflation, low pay-rise*

Average wage per employee (Total cash earnings)

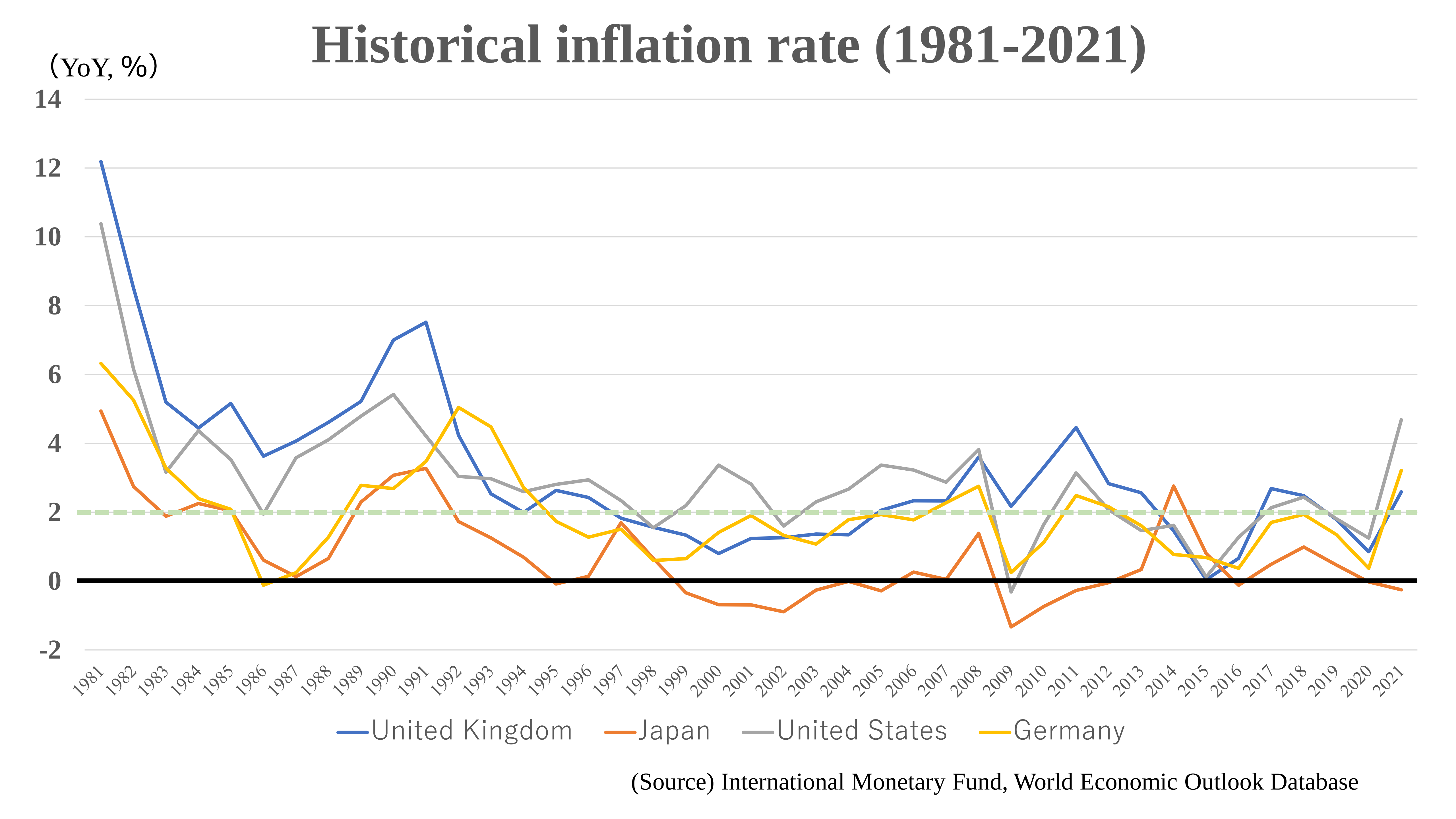


(Source) Ministry of Health, Labor and Welfare

Wage income of employees

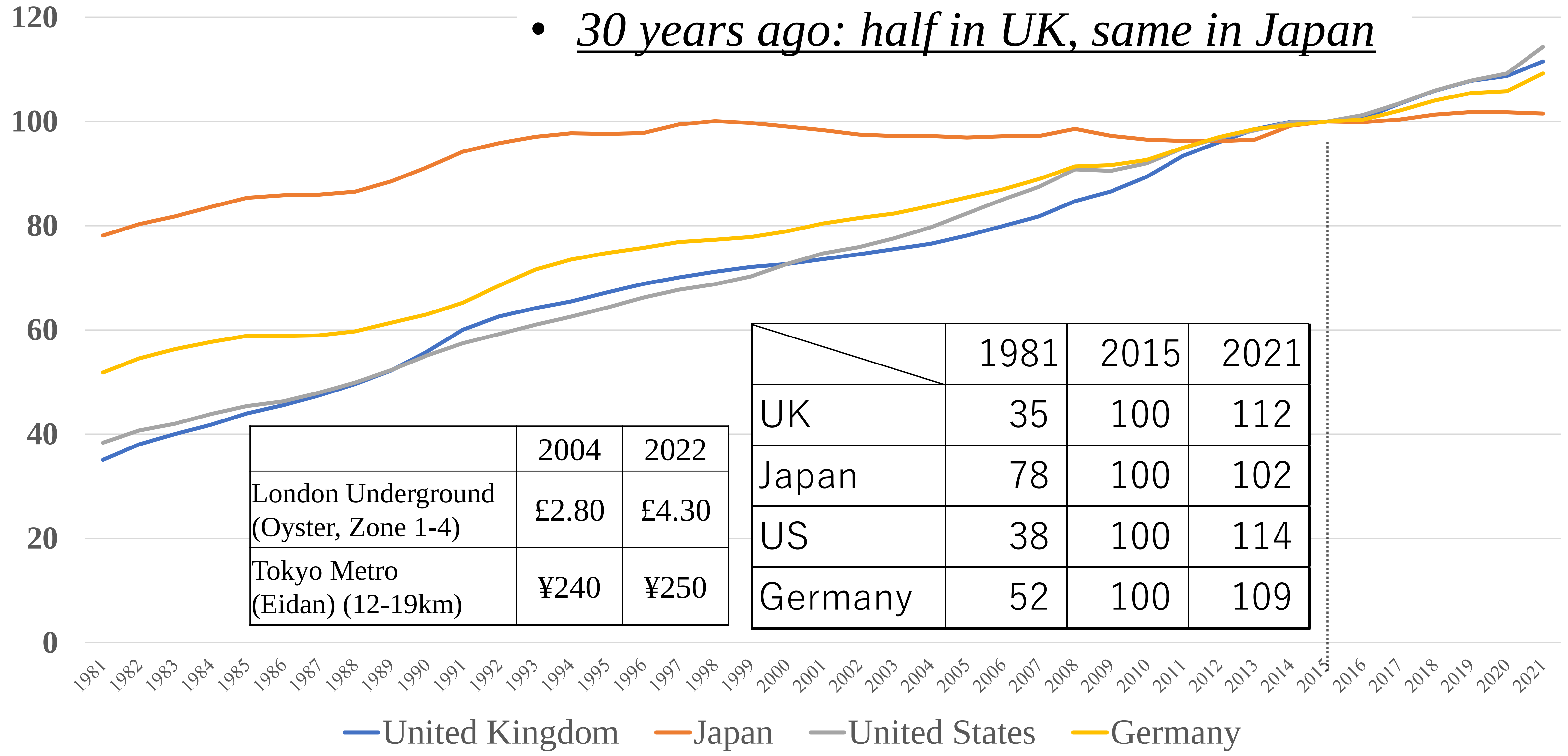


(Source) Cabinet Office


Historical inflation rate (1981-2021)
(YoY, %)
14
12
10
8
6
4
2
0
-2
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020
2021
United Kingdom
Japan
United States
Germany
(Source) International Monetary Fund, World Economic Outlook Database

Historical Inflation Index (2015=100)

- *30 years ago: half in UK, same in Japan*



	2004	2022
London Underground (Oyster, Zone 1-4)	£2.80	£4.30
Tokyo Metro (Eidan) (12-19km)	¥240	¥250

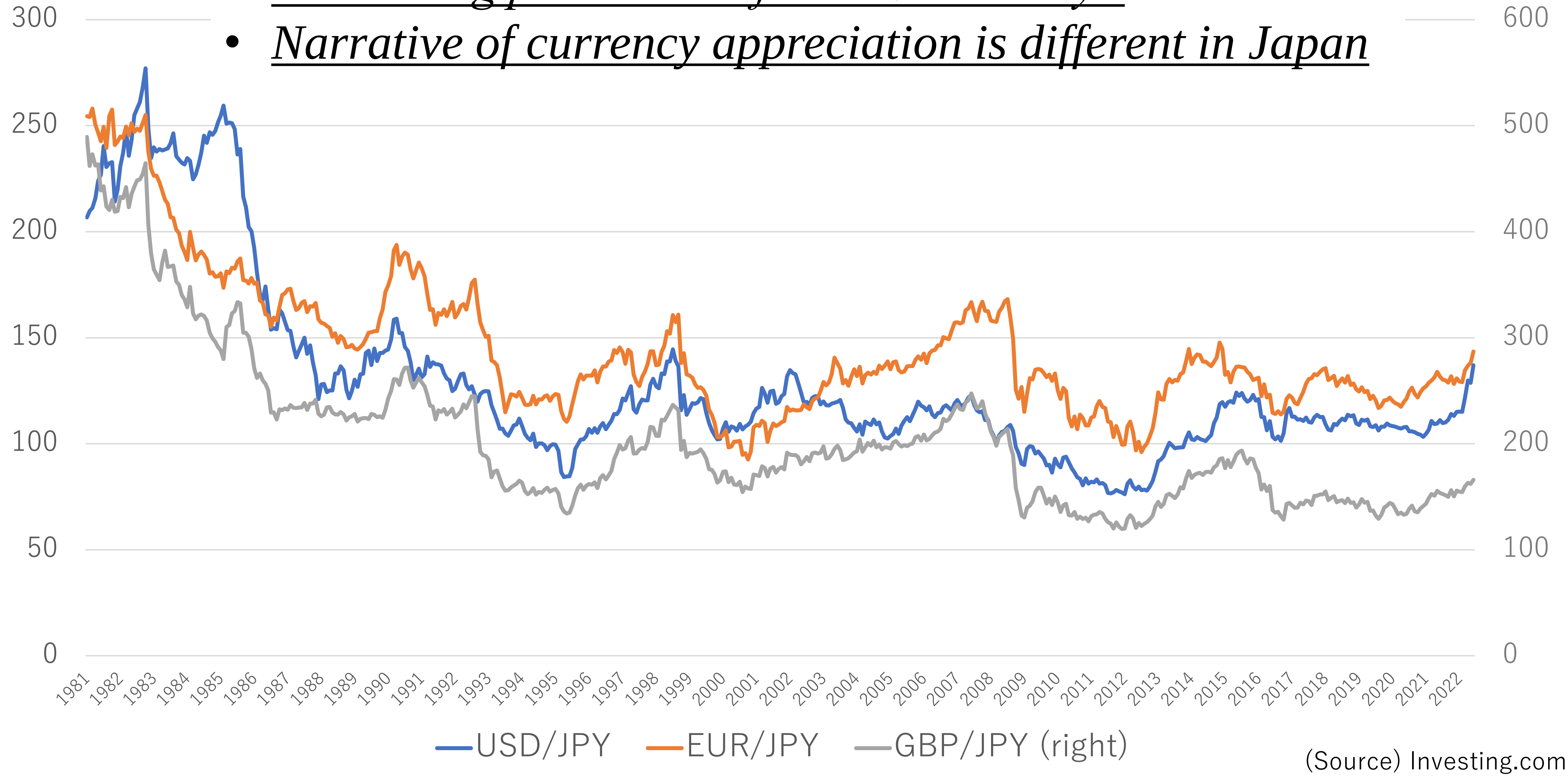
	1981	2015	2021
UK	35	100	112
Japan	78	100	102
US	38	100	114
Germany	52	100	109

(Source) International Monetary Fund, World Economic Outlook Database

*adjusted by the author to harmonize as "2015=100"

Historical rate of JPY with USD/EUR/GBP

- *Purchasing power is "inflation / currency"*
- *Narrative of currency appreciation is different in Japan*

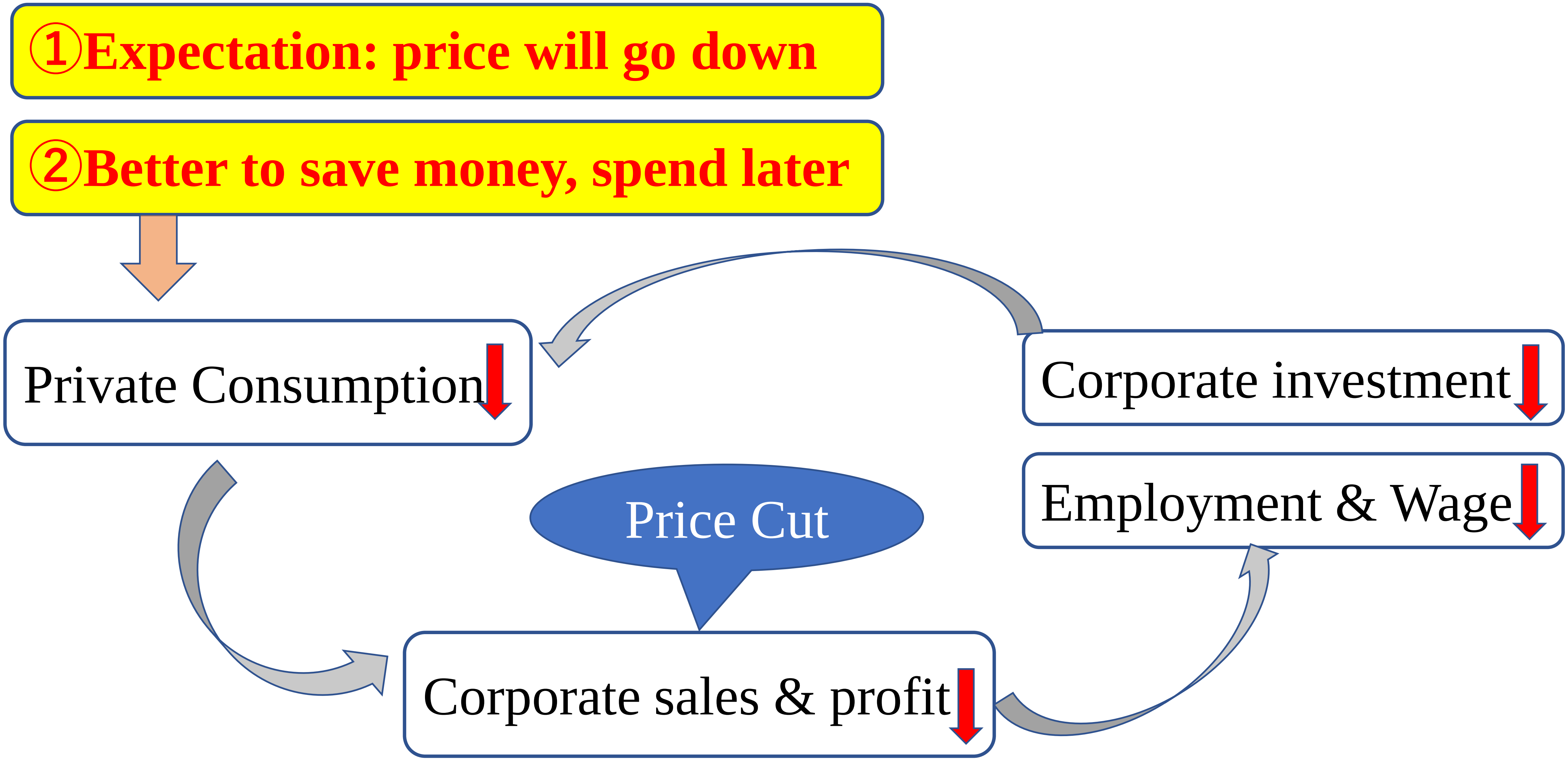


(Source) Investing.com

- *<u>Feeling guilty for raising the price</u>*
  <u>(You should learn, a little bit?)</u>

1991～2016 ：￥60
2016～(still)： ￥70

(2) Vicious circle of deflation



*all the bad things were associated with “deflation”

Investopedia *on sticky wage theory*

The theory is attributed to the economist John Maynard Keynes, who called the phenomenon “nominal rigidity" of wages.

KEY TAKEAWAYS

- Sticky wage theory argues that employee pay is resistant to decline even under deteriorating economic conditions.
- This is because workers will fight against a reduction in pay, and so a firm will seek to reduce costs elsewhere, including via layoffs, if profitability falls.
- Because wages tend to be "sticky-down", real wages are instead eroded through the effects of inflation.
- A key piece of Keynesian economic theory, "stickiness" has been seen in other areas as well such as in certain prices and taxation levels.

Theory in practice

- *Deflation benefits permanent workers in declining industries and corporates*

Price	Profit	Nominal Wage	Real Wage
Inflation	Upward	↑ ↑ ↑	↑ ↑
	Downward	→	↓
Deflation	Upward	↑	↑ ↑
	Downward	→	↑

- Shift toward temporary employment
- Become more cautious on wage hike

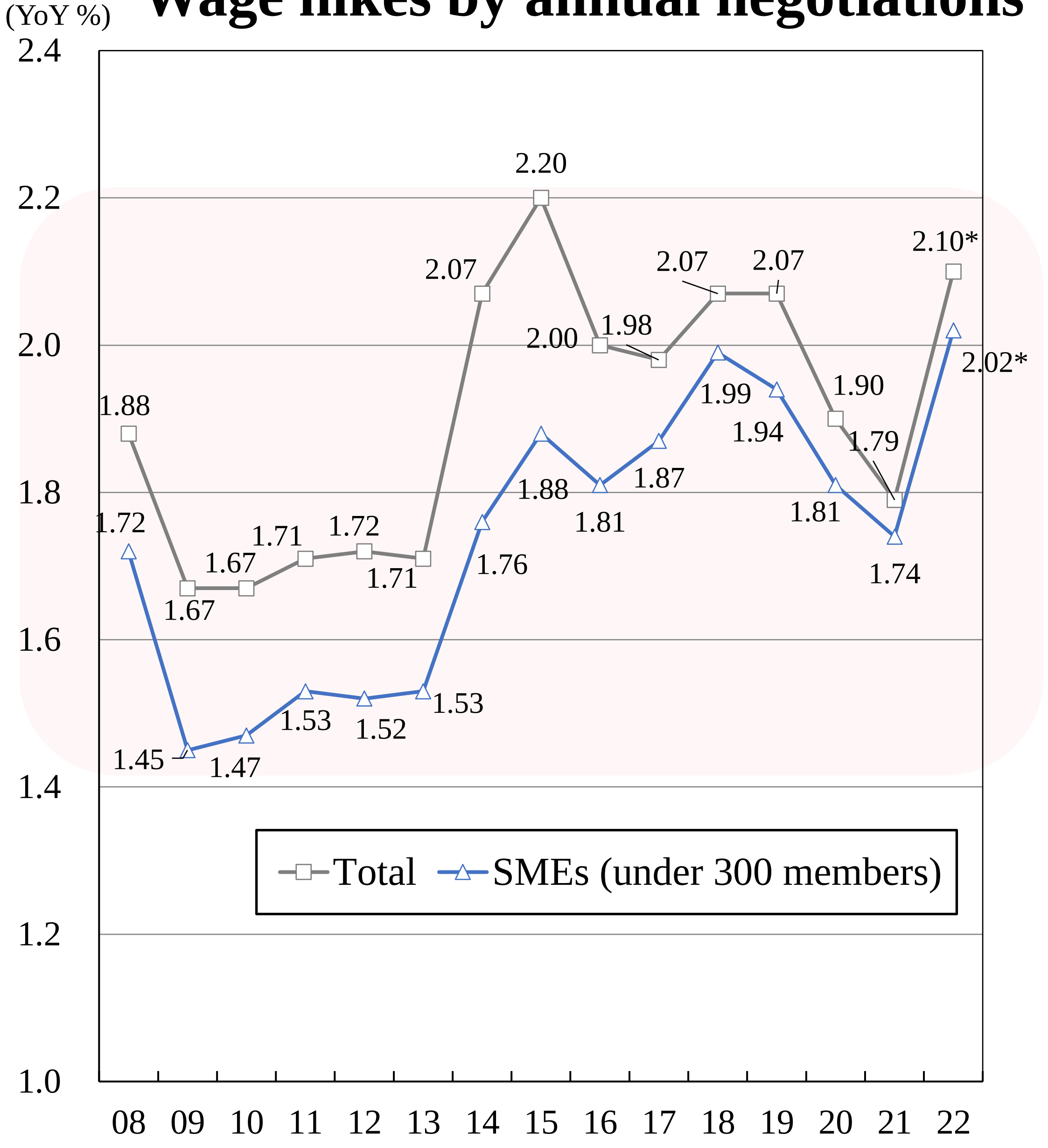
- Prioritize long-term job protection

- *Pay-rise for unionized workers has been modest, but cannot be lower than negative inflation rate*

Consumer price index

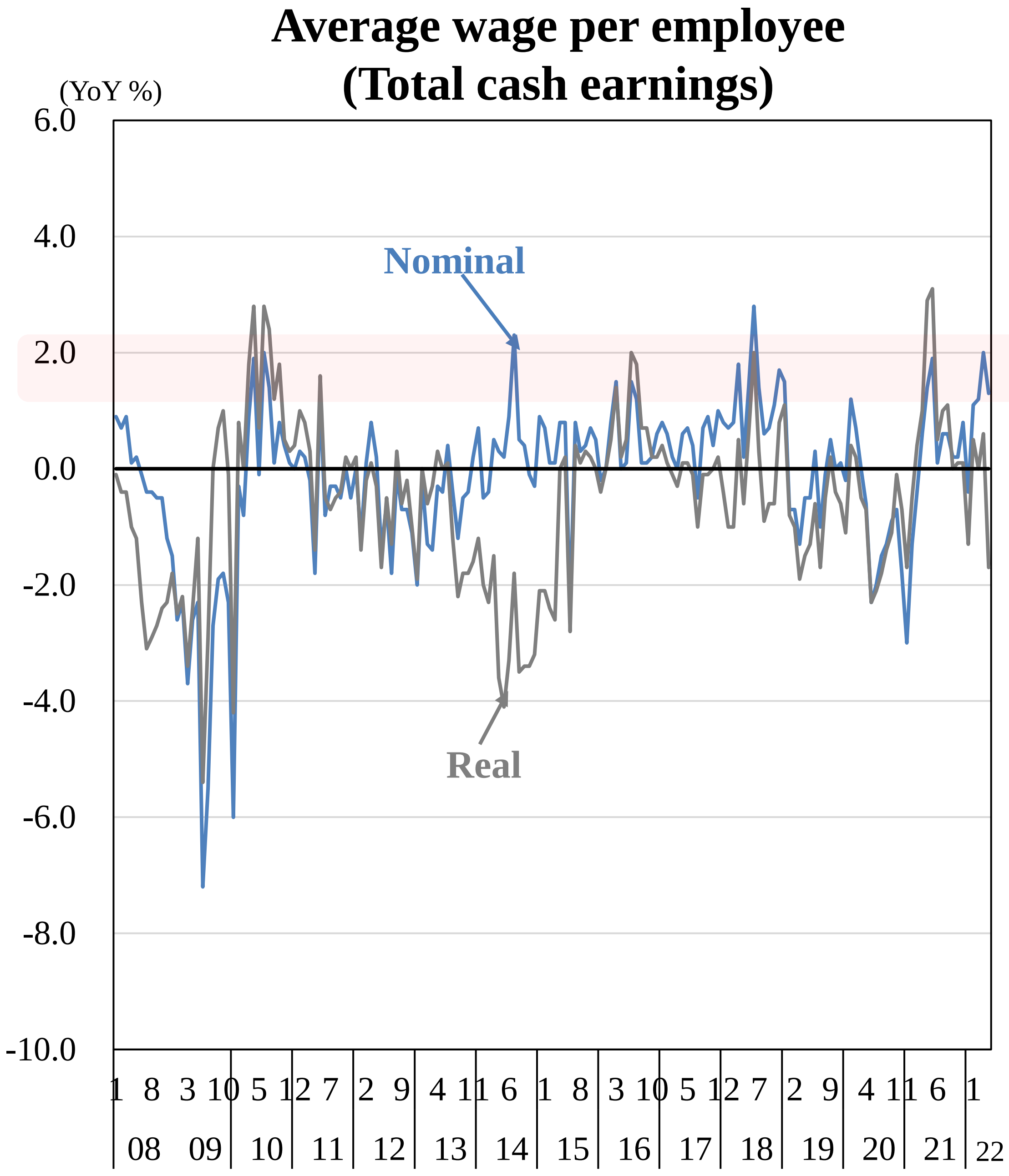
(Source) Ministry of Internal Affairs and Communications

Wage hikes by annual negotiations

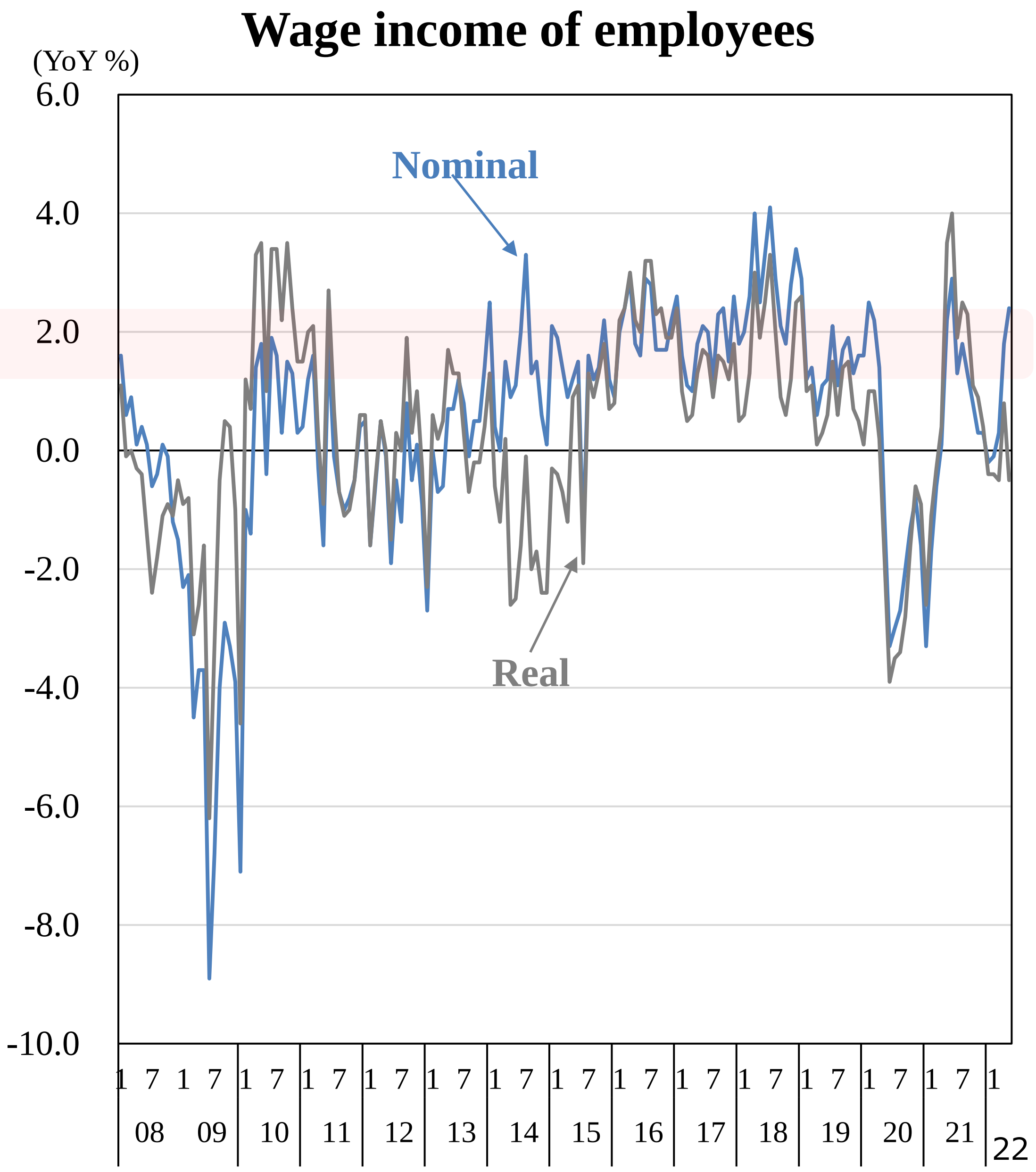


(*) 6th aggregate results (Source) Rengo (Japanese Trade Union Confederation)

- *On macroeconomic scale, wage growth was sometimes negative.*



(Source) Ministry of Health, Labor and Welfare

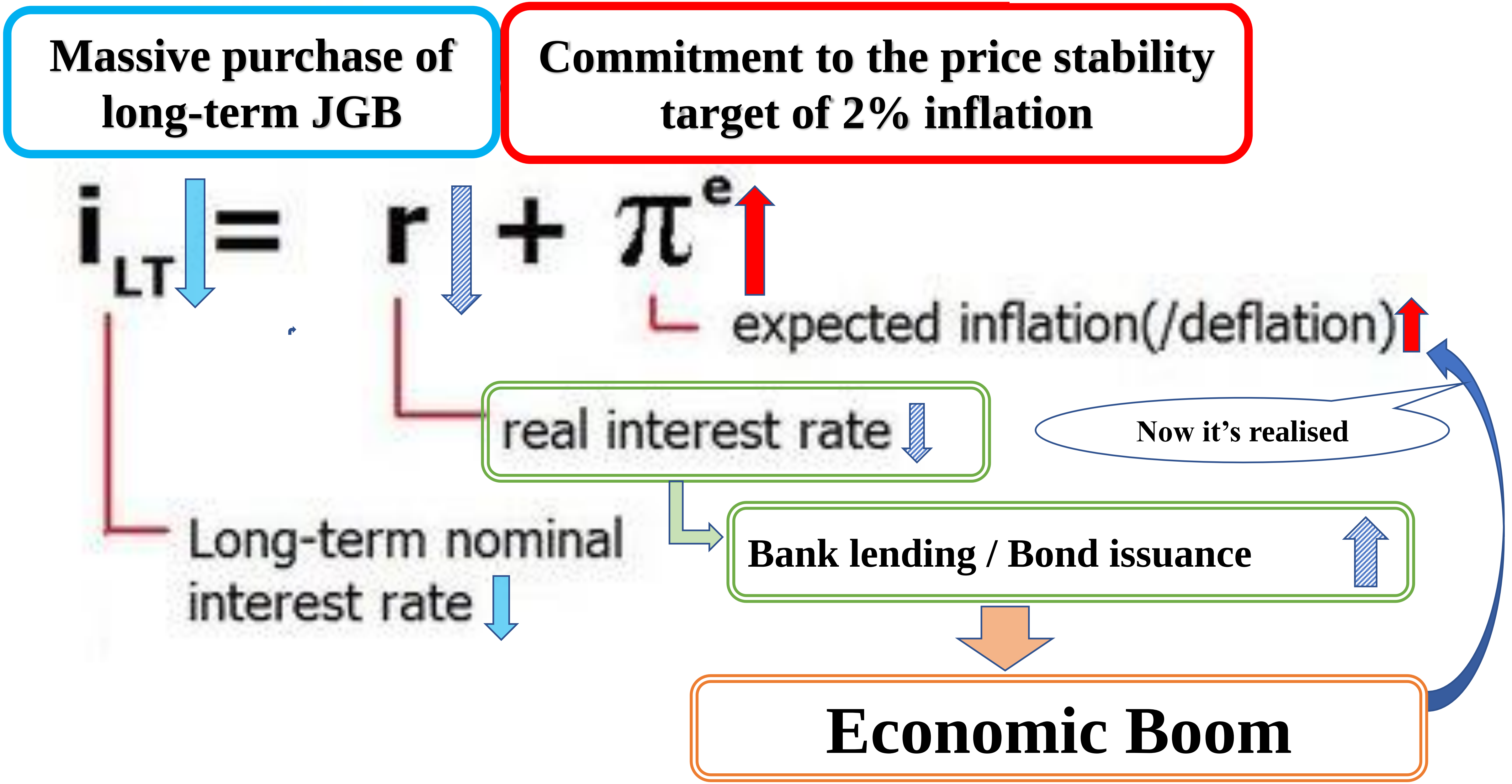


(Source) Cabinet Office

(3) Legacy of anti-deflation: Quantitative and Qualitative Monetary Easing (QQE)

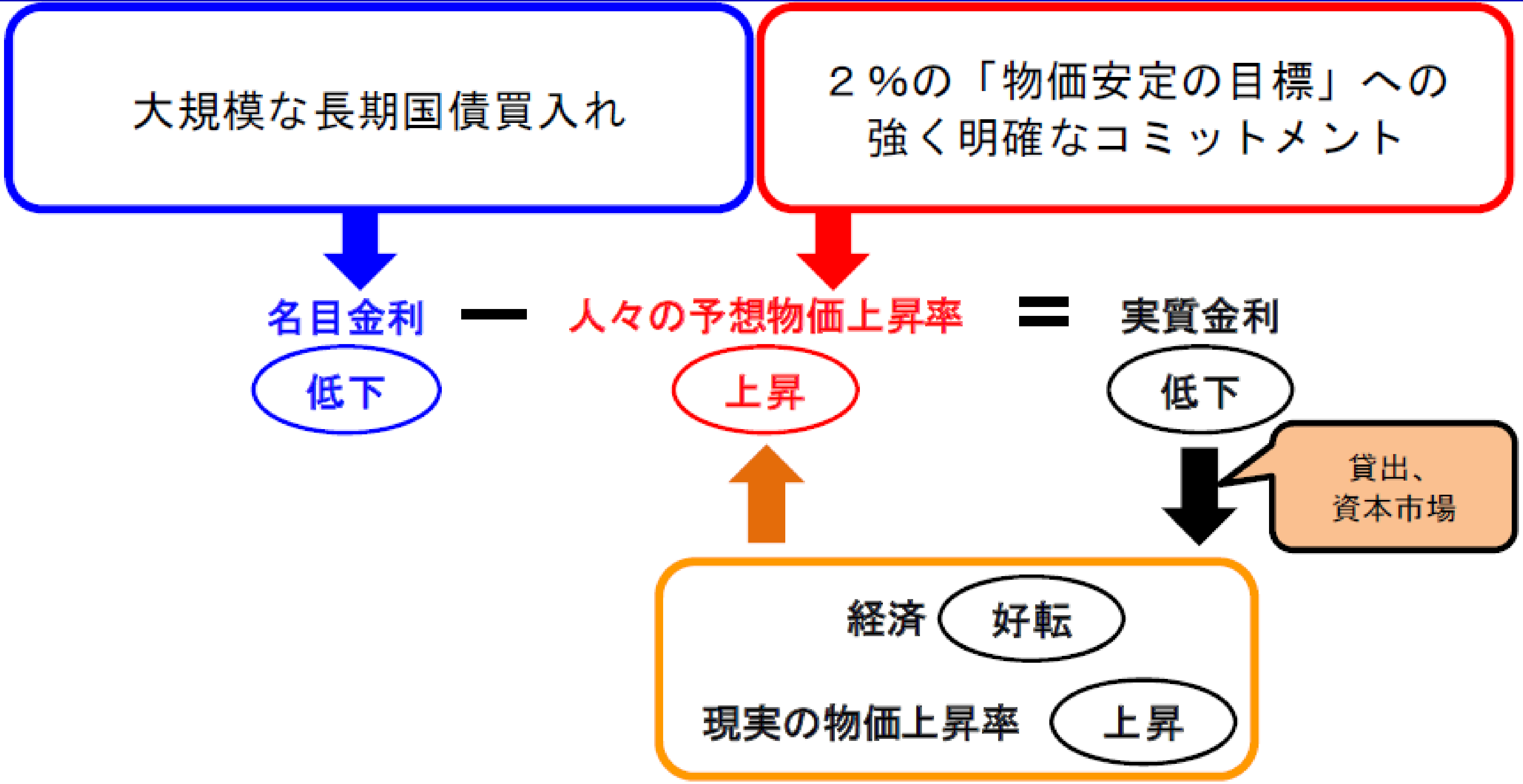
Basic mechanism of QQE

- *One commitment, one action (plus more actions)*



「量的・質的金融緩和」のメカニズム

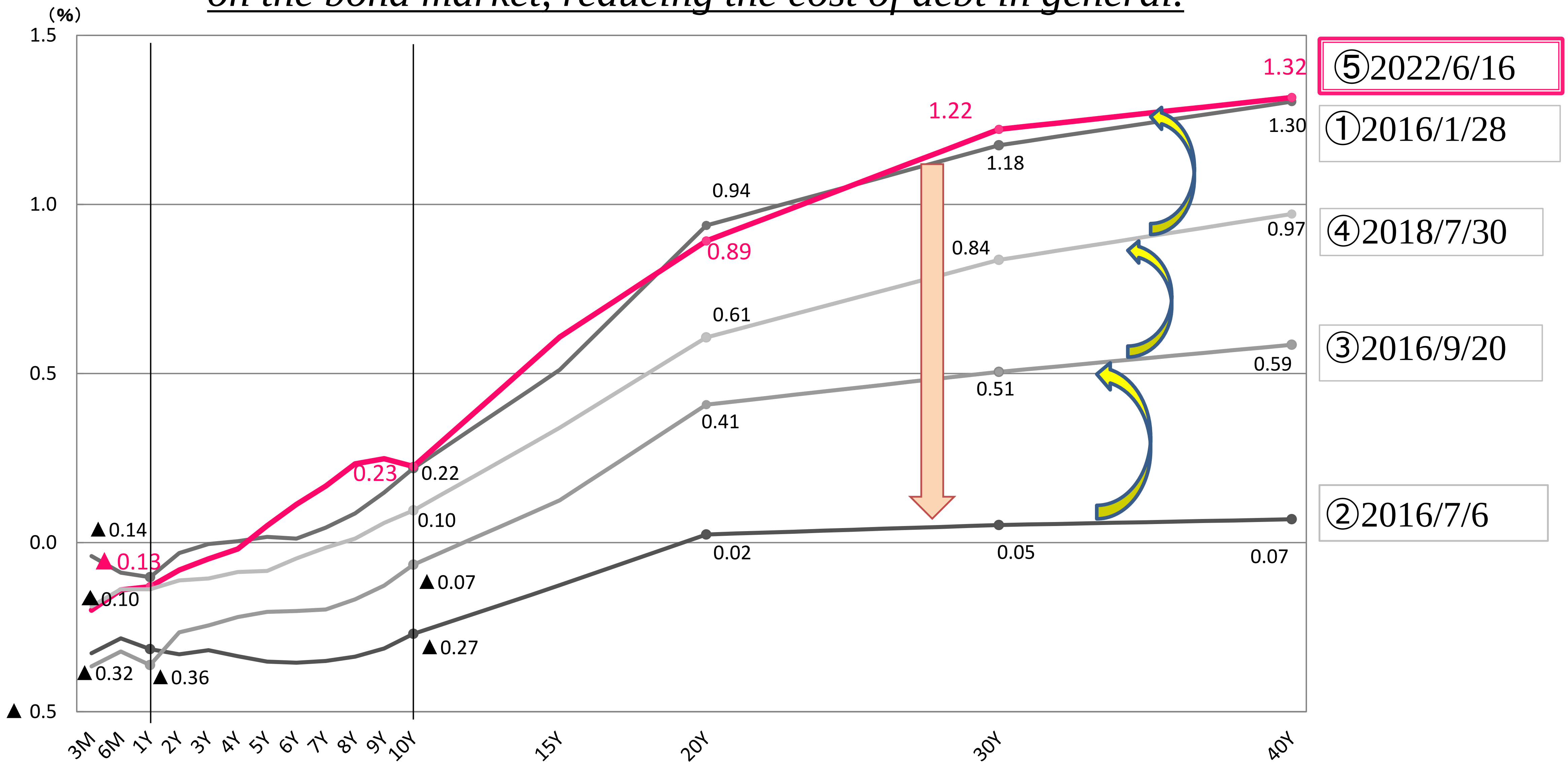
Original:
Lecture by Bank of Japan Governor Mr. Kuroda in June 2016 at Keio University



（出所）日本銀行黒田総裁　慶應義塾大学における講演資料（2016年6月20日）

Yield Curve of JGB

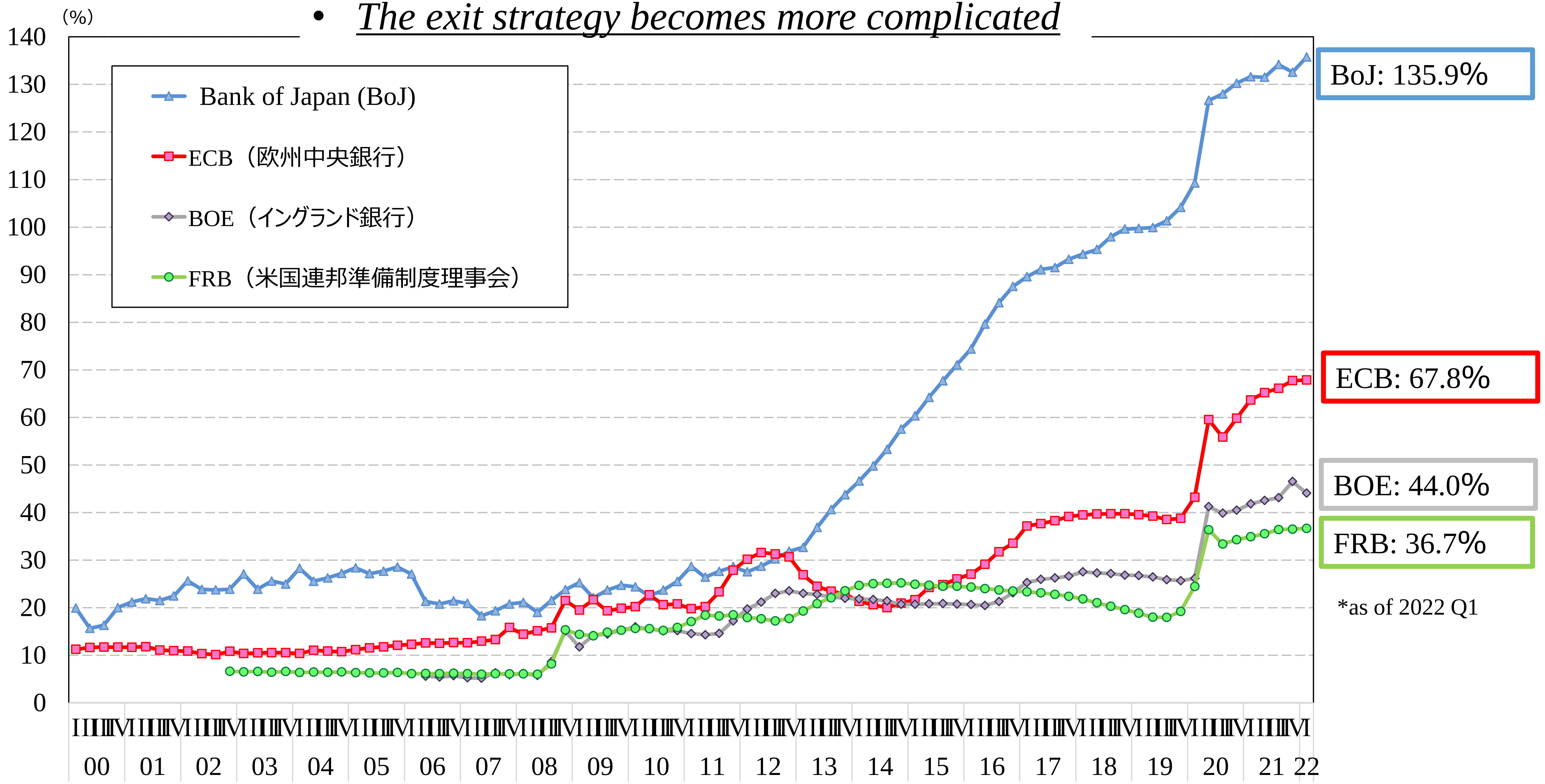
- *Negative interest rate policy (2016 Jan) worked very strongly on the bond market, reducing the cost of debt in general.*



(Source) Bloomberg

Balance sheet of major central banks (ratio to GDP)

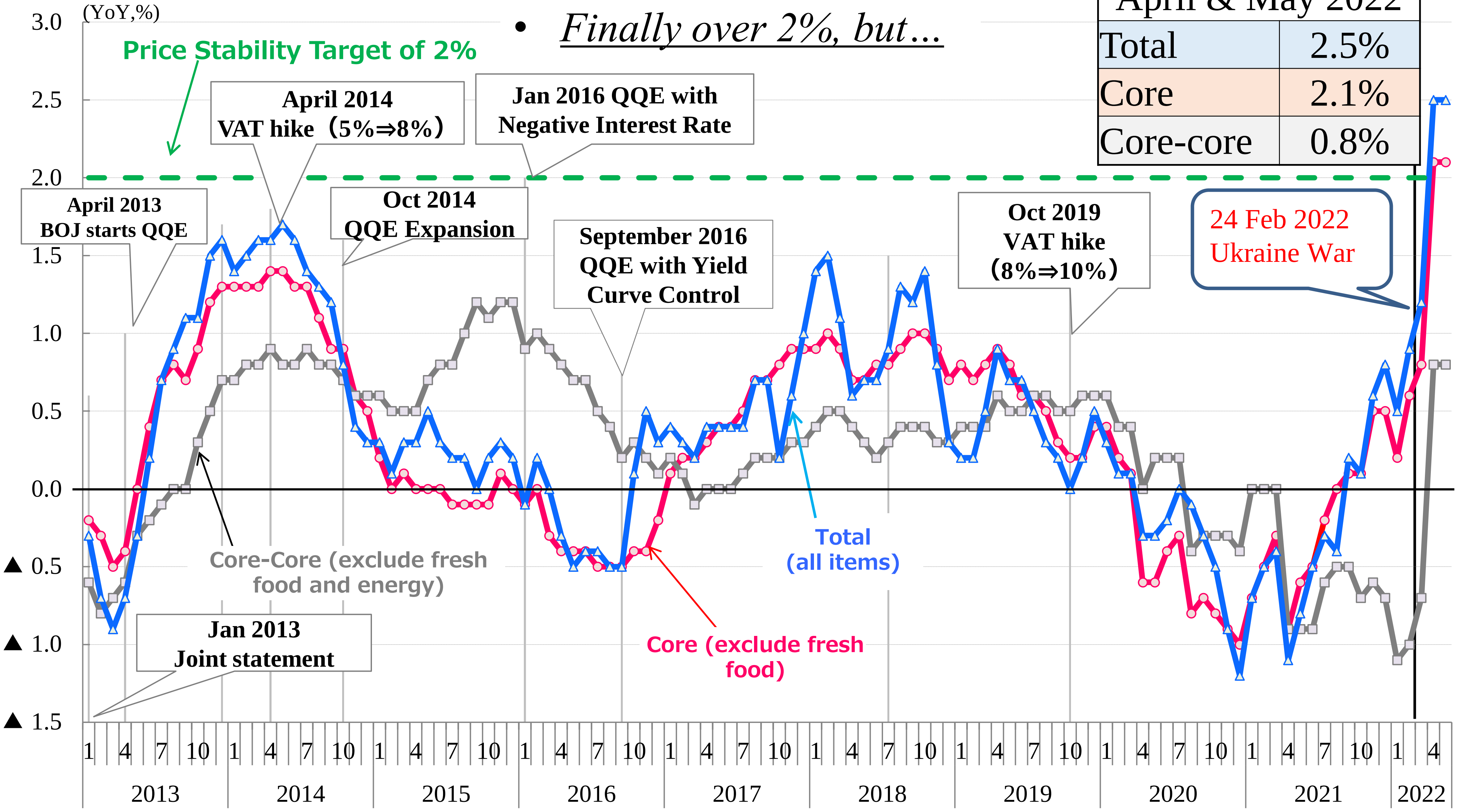
- *The exit strategy becomes more complicated*



CPI (excluding tax hike)

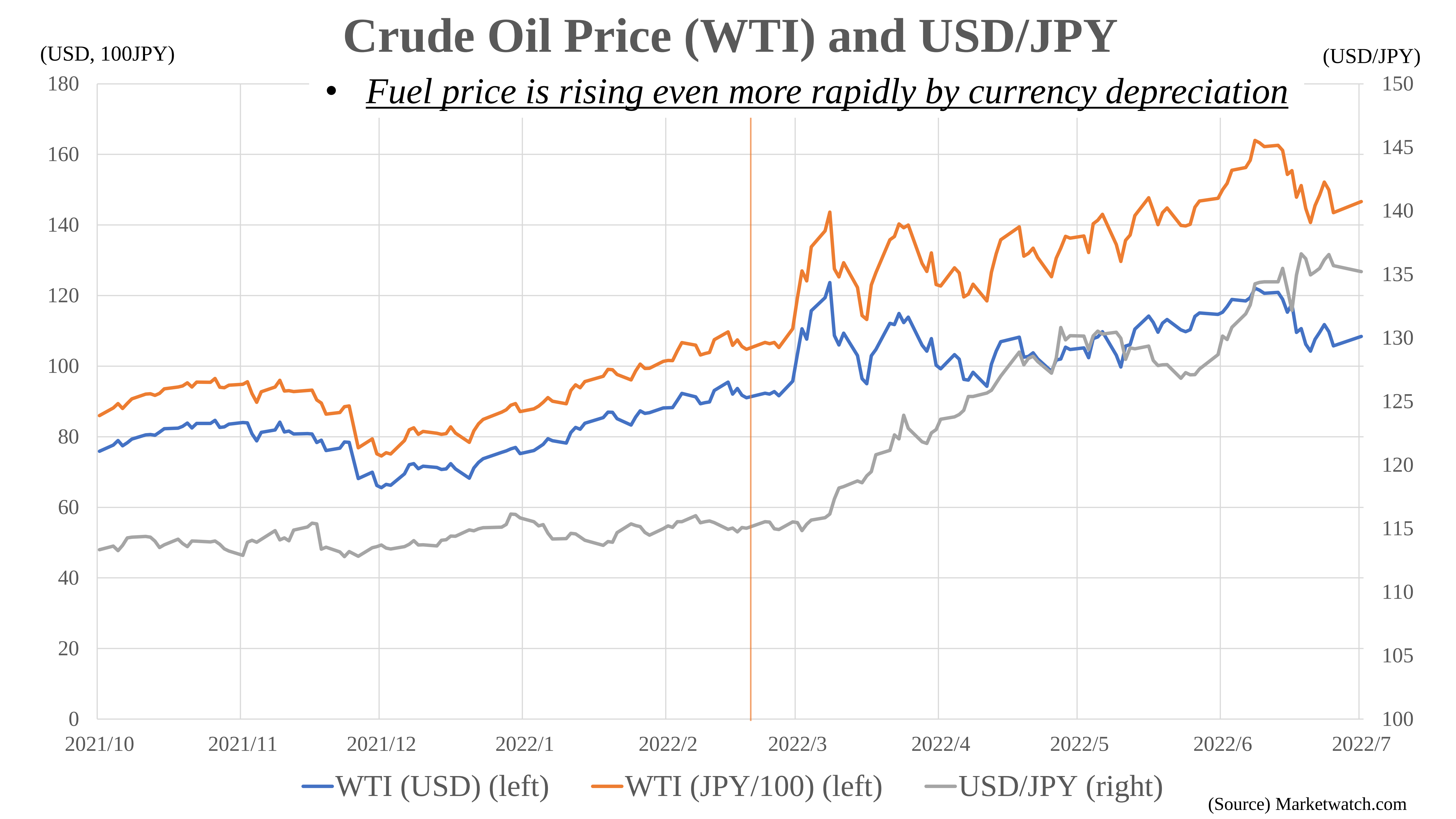
- *Finally over 2%, but…*

April & May 2022	
Total	2.5%
Core	2.1%
Core-core	0.8%



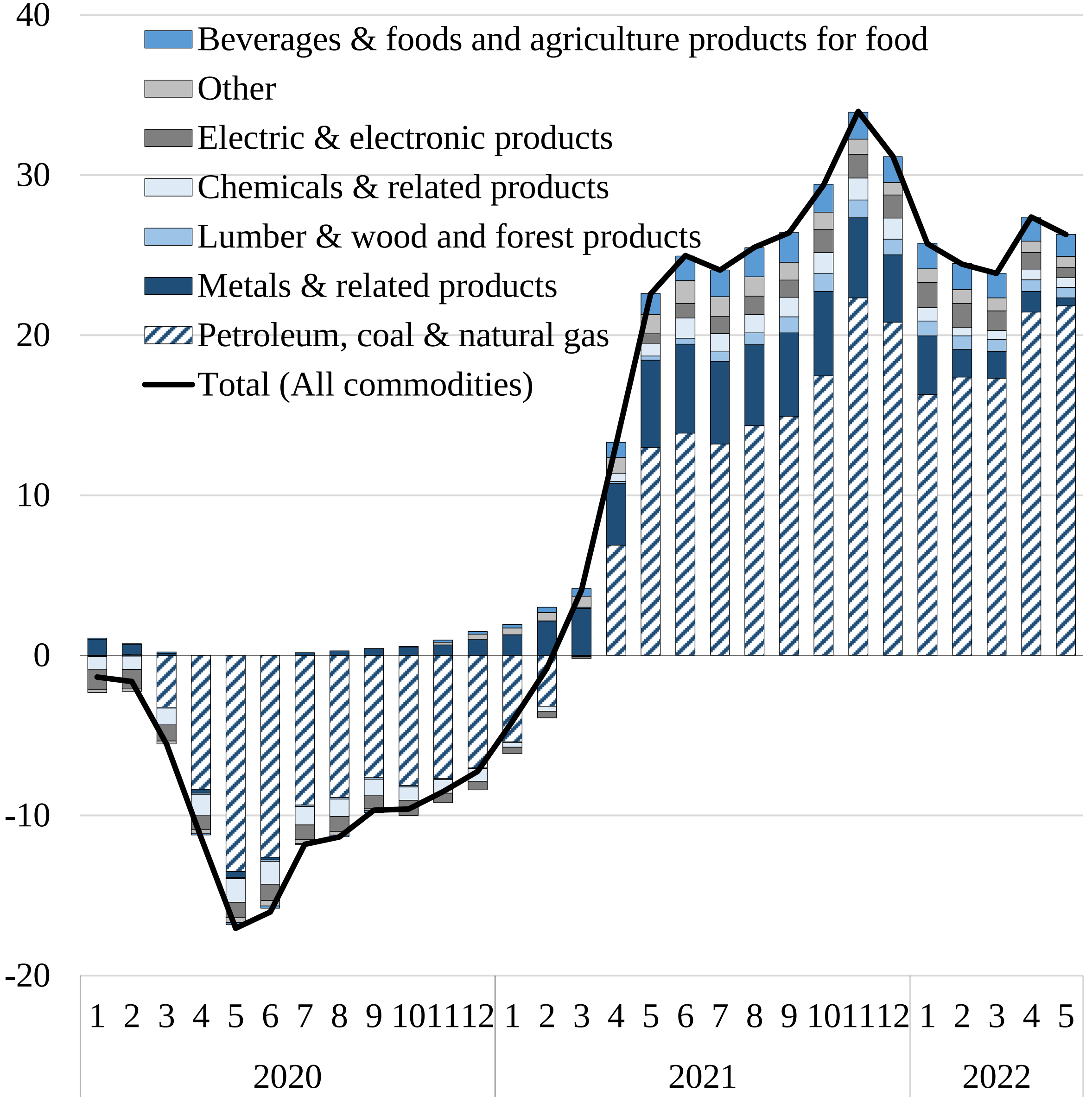
(Source) Ministry of Internal Affairs and Communications, Bank of Japan

(4) Recent development: food & energy crisis from the Ukraine War


Crude Oil Price (WTI) and USD/JPY
(USD, 100JPY)
(USD/JPY)
• Fuel price is rising even more rapidly by currency depreciation
180
160
140
120
100
80
60
40
20
0
150
145
140
135
130
125
120
115
110
105
100
2021/10
2021/11
2021/12
2022/1
2022/2
2022/3
2022/4
2022/5
2022/6
2022/7
WTI (USD) (left)
WTI (JPY/100) (left)
USD/JPY (right)
(Source) Marketwatch.com

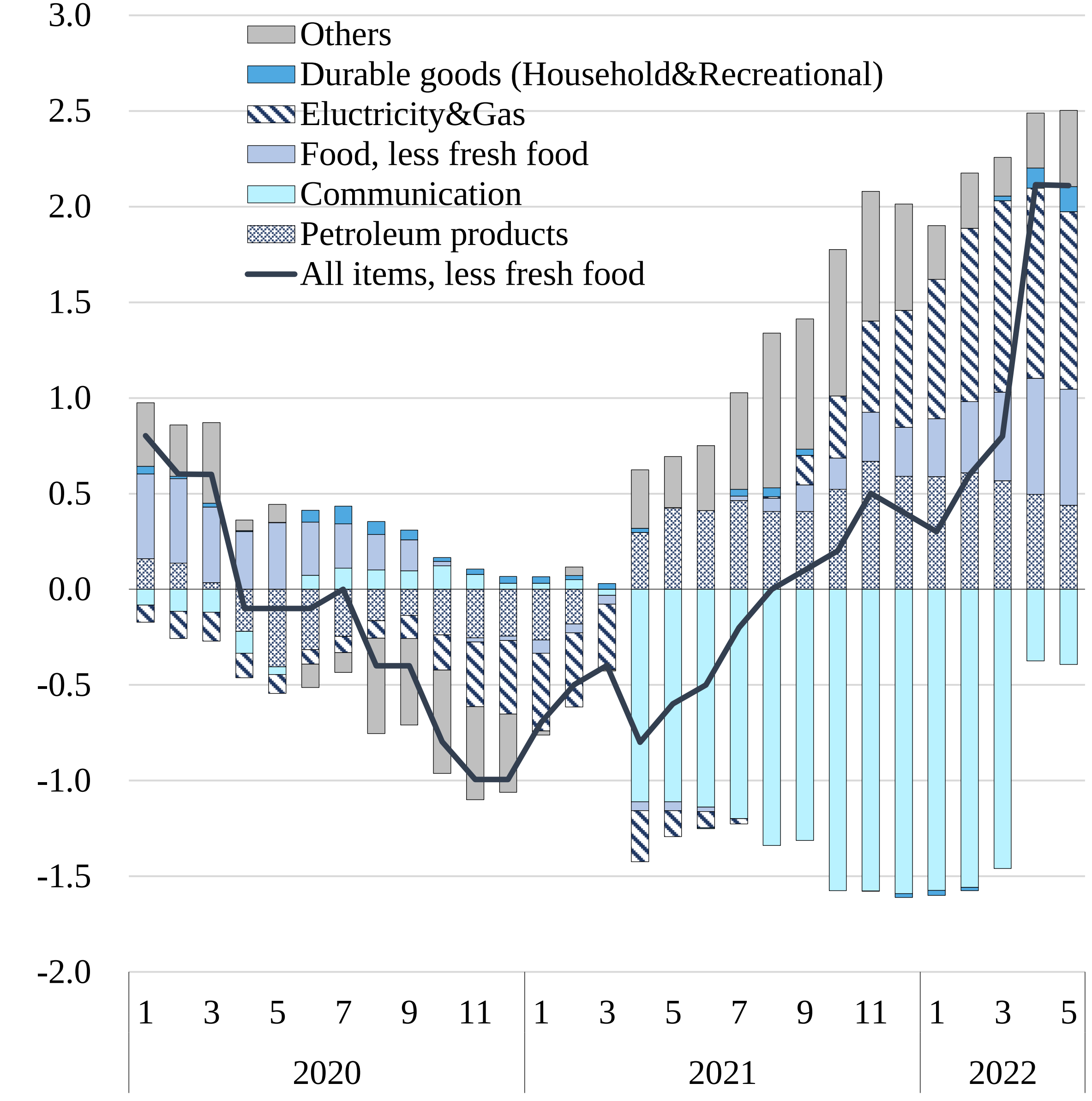
Import price index

- *Inflationary pressure started last summer*



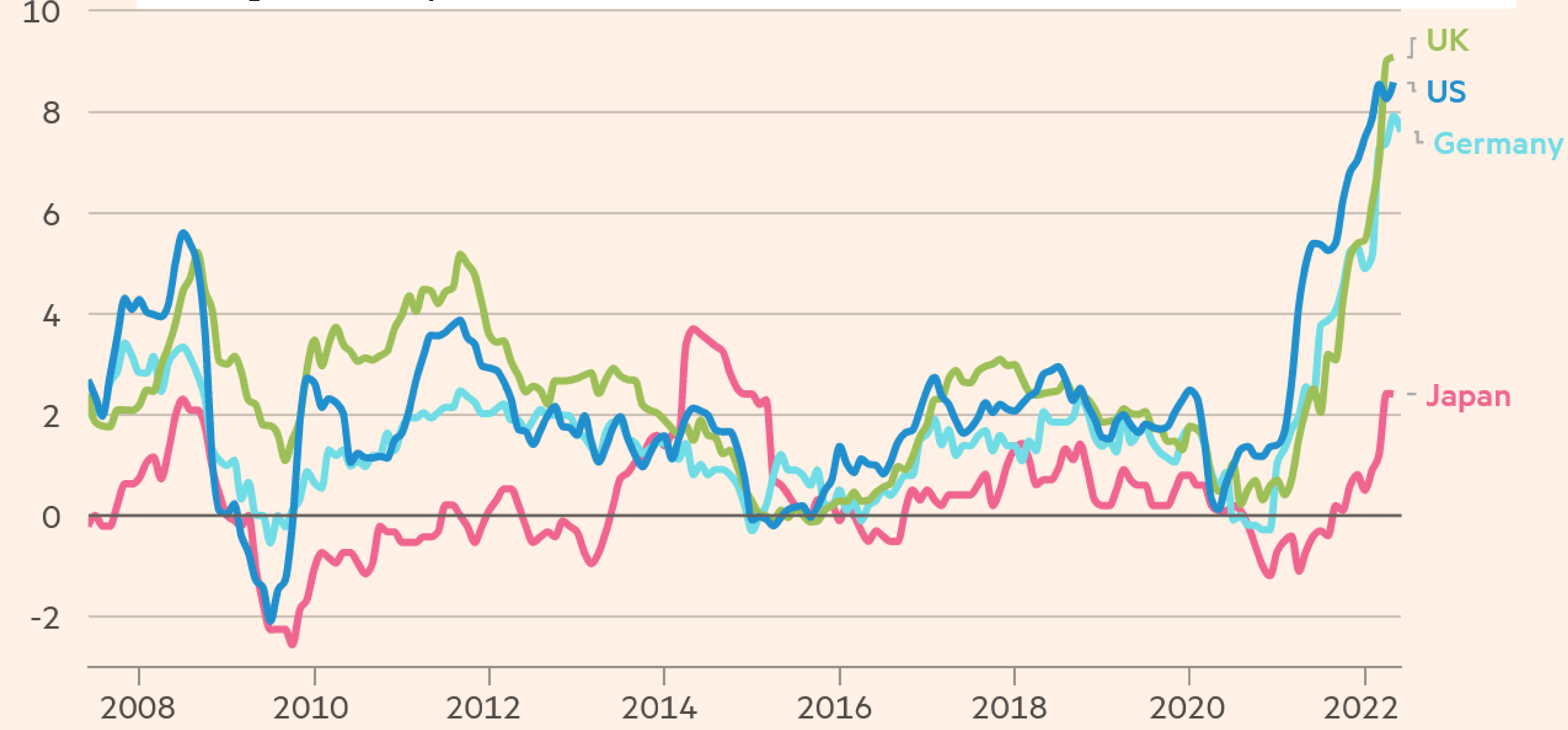
CPI

- *Policy effect on mobile communication bill*



(Source) Bank of Japan, Ministry of Internal Affairs and Communications

- *Japanese inflation looks modest, but is on the same trend with others*



FINANCIAL TIMES

Sources: Refinitiv; national statistics offices

Top contributing items (May 2.5%)

- <u>*Supposed to be dominated by "Demand-Pull", not by "Cost-Push"*</u>

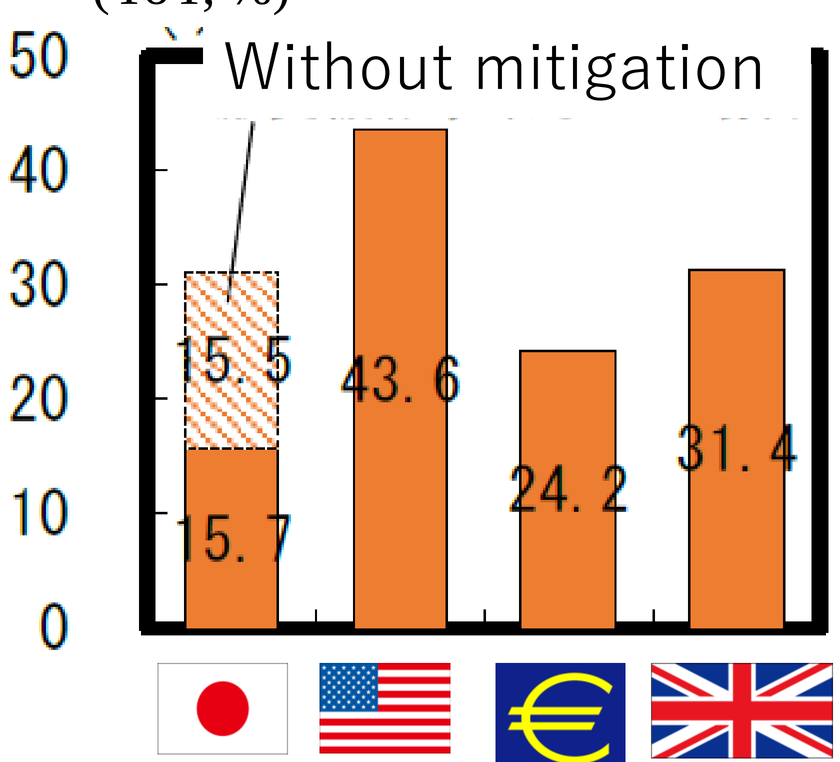
Item	Category	YoY change (%)	Contribution (%pt)	Reason	Policy measures so far
Electricity	Energy	19%	0.63	Cost-Push	Limit on price change Long-term LNG contract
Gasoline	Energy	13%	0.27	Cost-Push	Mitigation subsidy
Gas (Piped)	Energy	22%	0.21	Cost-Push	Limit on price change Long-term LNG contract
Onion	Fresh Food	125%	0.13	Weather	Import diversification of fertiliser
Kerosene (heating)	Energy	25%	0.11	Cost-Push	Mitigation subsidy
Hotel	Others	5%	0.05	Demand-Pull	
Gas (LPG)	Energy	9%	0.05	Cost-Push	Mitigation subsidy
Cooking Oil	Food (non-fresh)	36%	0.04	Cost-Push	

Mobile communication	Transport & Communication	-23%	-0.37	Policy effect	

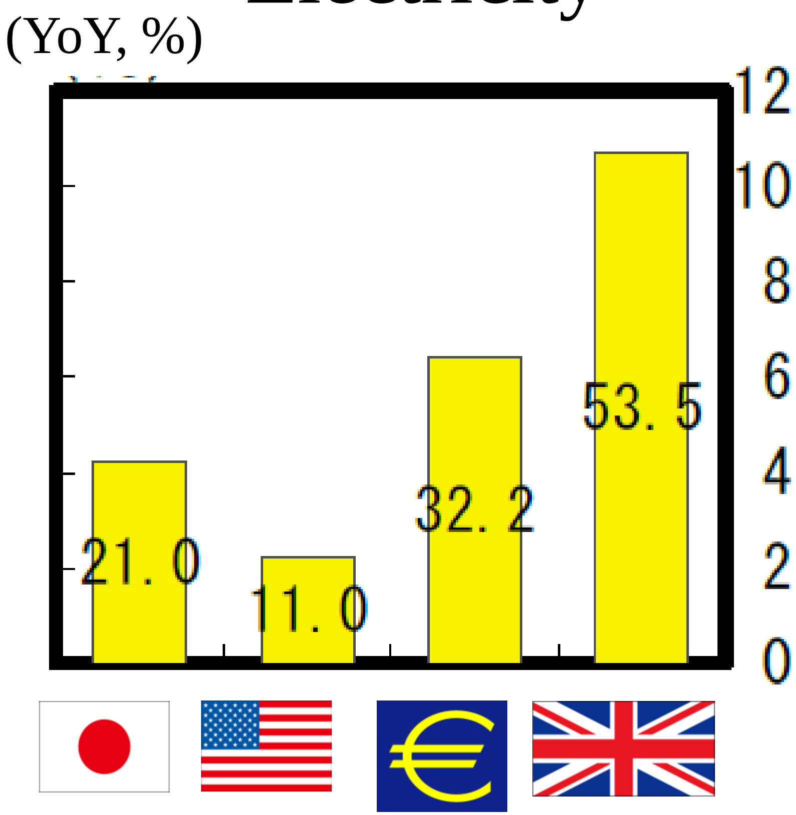
Cost of living crisis (April)

- *Apparently modest in Japan, but the delay of pay-rise makes it more painful*

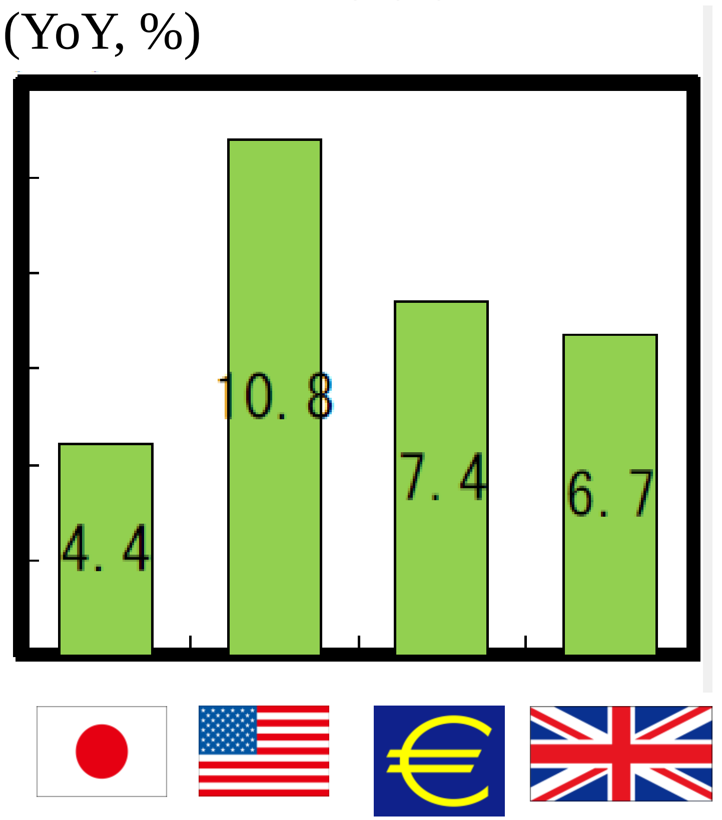
Gasoline



Electricity



Food



(Source: Cabinet Secretariat) (translated by the author)
*First meeting of the government's new task force to tackle rising prices caused by Russia's invasion of Ukraine (21 June)

Statement on Monetary Policy (17 June, Bank of Japan)

- *(1) Temporary! (2) Core-core CPI (exclude energy) should rise as well. (3)Cost pass-through is the key!*

[Inflation] is likely to be at around 2% for the time being due to the impact of rises in energy and food prices, but it is expected to decelerate thereafter because the positive contribution of the rise in energy prices to the CPI is likely to wane. Meanwhile, the year-on-year rate of change in the CPI (all items less fresh food and energy) is expected to moderately increase in positive territory on the back of improvement in the output gap and rises in medium- to long-term inflation expectations and wage inflation, and partly also of a pass-through of raw material cost increases.

(Original in Japanese)

【インフレ】当面、エネルギーや食料品の価格上昇の影響により、２％程度で推移するとみられるが、その後は、エネルギー価格の押し上げ寄与の減衰に伴い、プラス幅を縮小していくと予想される。この間、消費者物価（除く生鮮食品・エネルギー）の前年比は、マクロ的な需給ギャップが改善し、中長期的な予想物価上昇率・賃金上昇率も高まっていくもとで、原材料コスト上昇の価格転嫁の動きもあって、プラス幅を緩やかに拡大していくとみられる

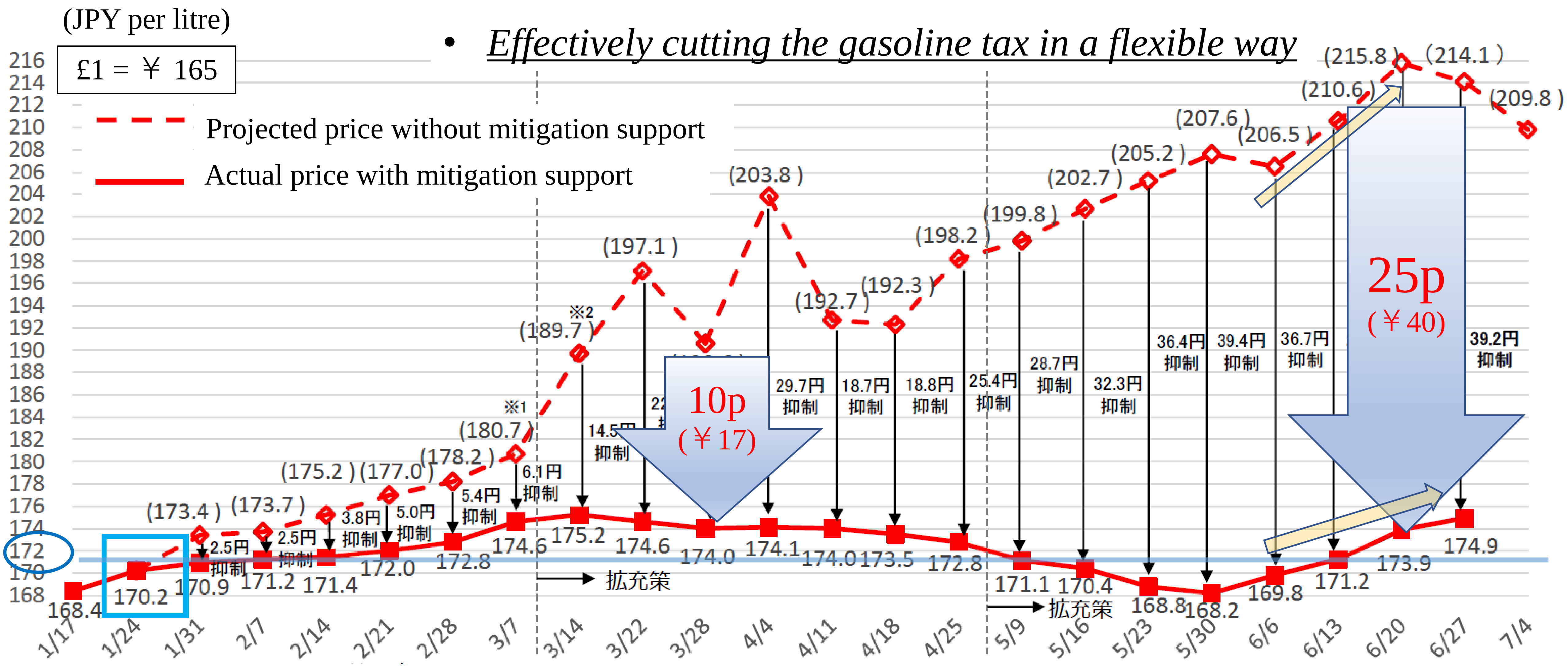
(5) Policy measures on cost of living

Petrol

Import: 100%

Petrol price in Japan

- *Effectively cutting the gasoline tax in a flexible way*



*Gasoline tax rate: ￥ 53.8/ℓ(33pence)

*Gasoline tax revenue: ￥ 2.3 trillion (£14 billion)

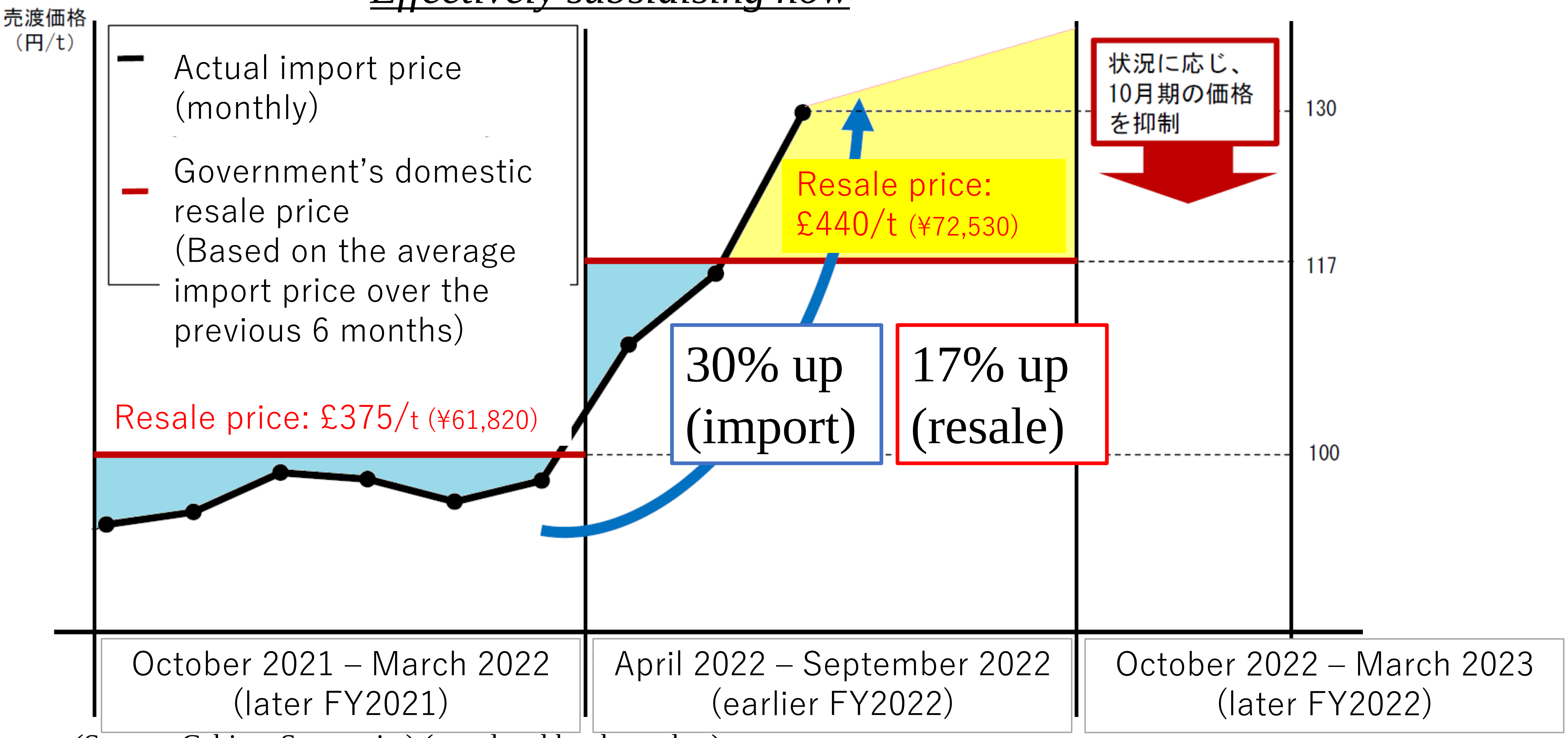
(Source: Agency for Natural Resources and Energy)
(translated by the author)

Wheat

Import: 85%

The government entity dominates the import of wheat

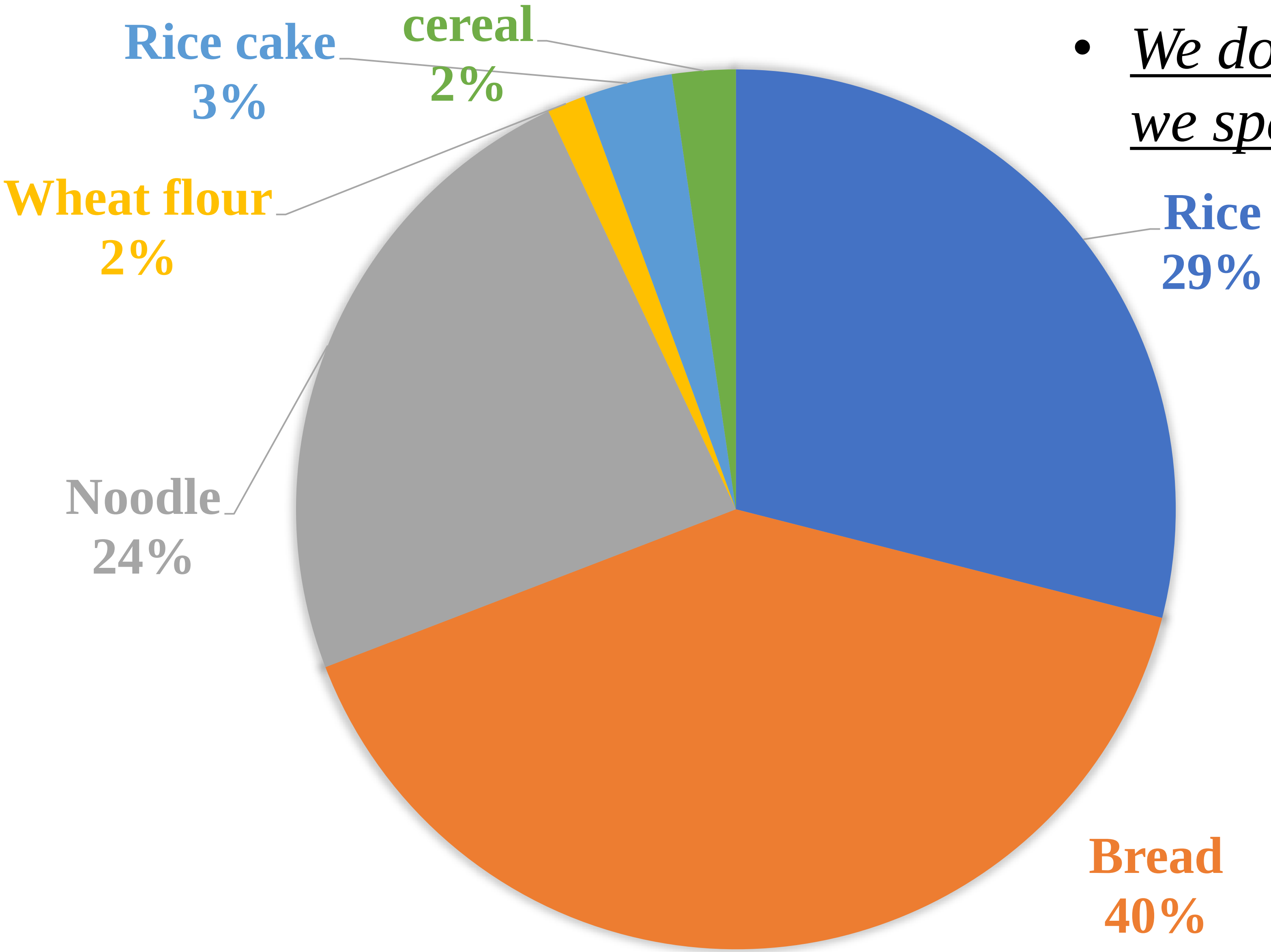
- *<u>Meant for the demand that domestic production cannot satisfy</u>*
- *<u>Effectively subsidising now</u>*



(Source: Cabinet Secretariat) (translated by the author)

*First meeting of the government's new task force to tackle rising prices caused by Russia's invasion of Ukraine (21 June)

Grain consumption: weight in purchasing (CPI)



- *<u>We do eat more rice, but we spend more on wheat</u>*

Quantity per person	
Rice	51kg
Wheat	32kg

Source: Ministry of Agriculture, Forestry and Fisheries (as of 2020)

Source: Ministry of Internal Affairs and Communications (as of FY2022)
(the author picked up “grain” section and calculated.)

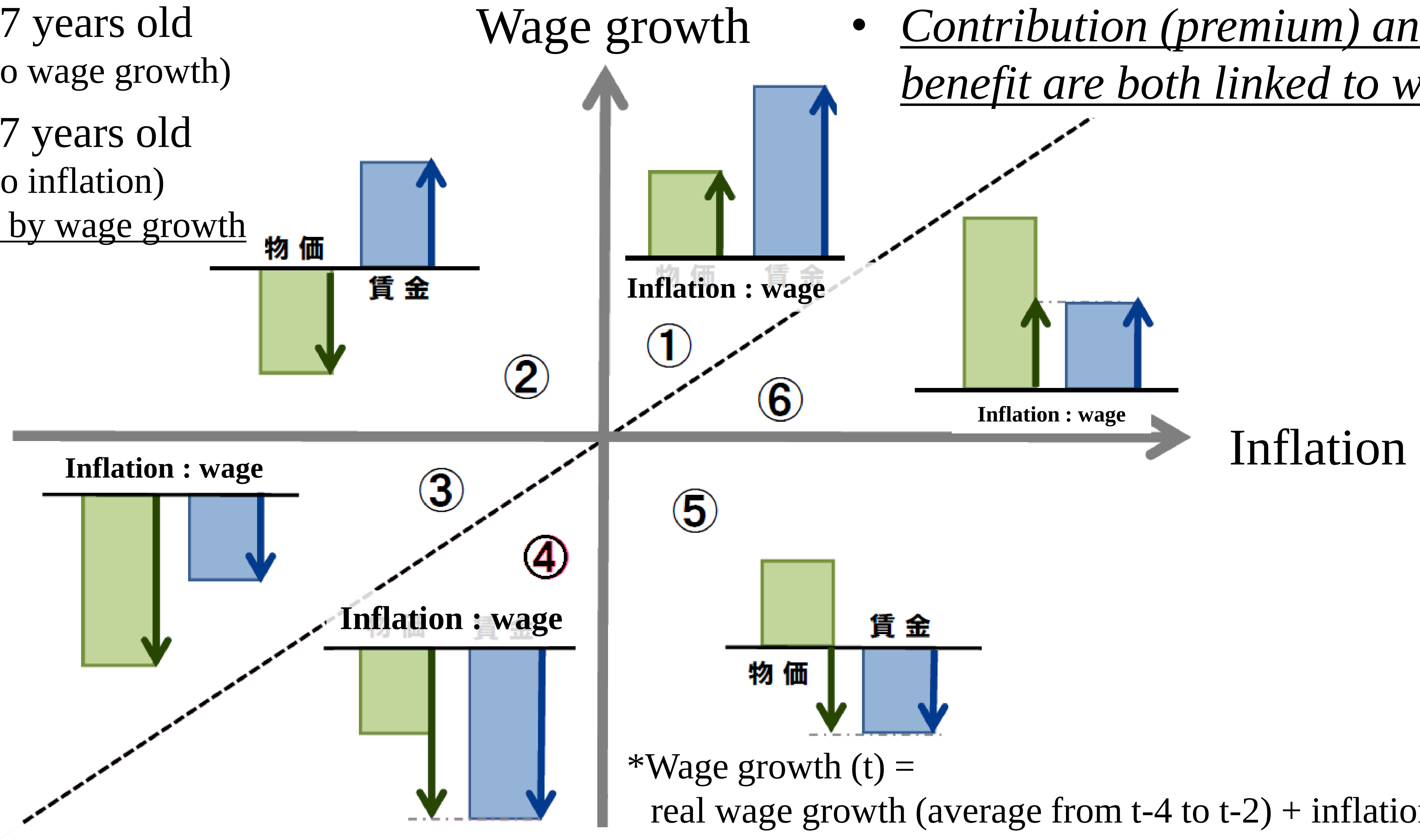
(6) Linkage to the public pension system

Revising scheme of public pension benefits

60 to 67 years old
(linked to wage growth)

Over 67 years old
(linked to inflation)
*<u>capped by wage growth</u>

- *<u>Contribution (premium) and benefit are both linked to wages</u>*



*Wage growth (t) =
real wage growth (average from t-4 to t-2) + inflation (t-1)

(Source) Ministry of Health, Labor and Welfare (translated and edited by the author)

(7) Summary & Remaining questions

Summary

1. The period of deflation is finally over, but led by “cost-push” inflation.
2. The cost pass-through effect is crucial. It takes time to transfer the rising cost of food & energy to the price of other goods & services, and the wages. The delay (absence) of pay-rise is making inflation more painful than it looks by the number (2.5%). It may take longer in Japan because the current mindset and structure have been formed during the decades of deflation. The key challenge is to make it faster.
3. Linkage to the pension system is complicated but well crafted.
4. Issues arising from sticky wage theory may change. On the macroeconomic scale, the nominal wage growth should be consistent with the inflation. However, the actual progress depends on the productivity growth of each sector.
5. The government is responding with flexible measures on fuel, wheat and others.

Remaining questions

- Trade-off: Administrative flexibility ⇔ Economic efficiency

- Tolerance:

  Can we restart the existing nuclear power plants to address climate change, cost-of-living crisis, and the dependence on Russian energy?

- Political will: What if we do the same opinion poll again?

  (English) In Japan, for example, an opinion poll by Kyodo News in April showed that 73.7% were in favour of tough economic sanctions, even if Japan's own economy is affected.

  (Japanese) 日本では、日本経済に影響が広がったとしても制裁を「続けるべきだ」との回答が73.7％（共同通信、4月）を占めた。

Thank you

(last but not least, overview of the Chatham House events related to the Ukraine War)