

Can Japan Achieve a Virtuous Cycle between Wages and Prices?

Tsutomu Watanabe

University of Tokyo & Nowcast Inc.

<https://sites.google.com/site/twatanabelab/>

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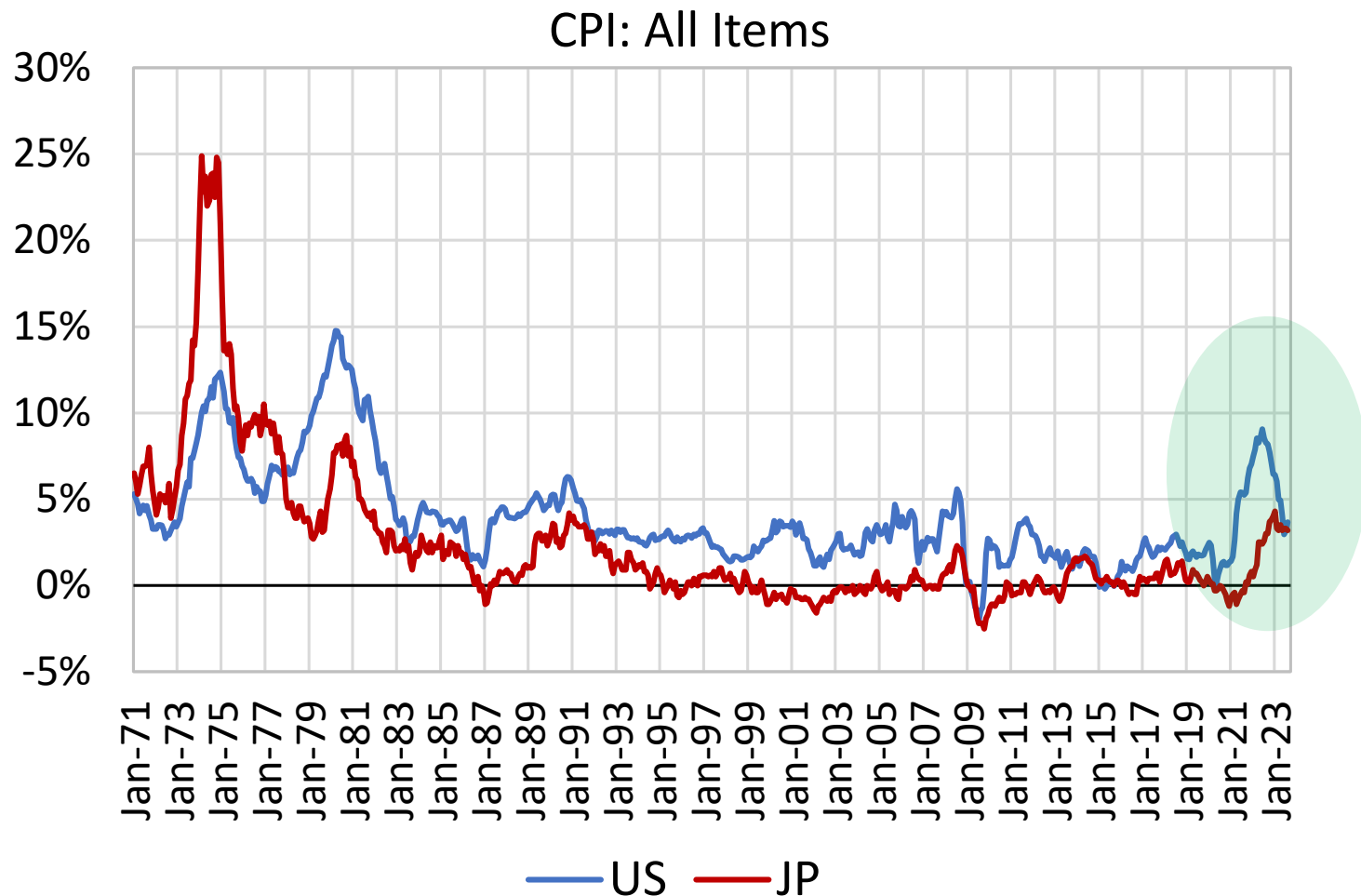
Research Projects on Inflation Dynamics, Economic Networks, and Central Bank Communication

- Principal Investigator, Research Project on **Inflation Dynamics in the Japanese Economy: An Approach Integrating Microeconomic Behaviors and Aggregate Fluctuations**, 2006-2011, Japan Society for the Promotion of Science, <http://www.ier.hit-u.ac.jp/~ifd/>
- Principal Investigator, Research Project on **Design of Interfirm Networks to Achieve Sustained Economic Growth**, 2008-2013, Ministry of Education, Sports, Science and Technology, <http://www.ier.hit-u.ac.jp/ifn/>
- Principal Investigator, Research Project on **Understanding Persistent Deflation in Japan**, 2012-2017, Japan Society for the Promotion of Science, <http://www.price.e.u-tokyo.ac.jp/>
- Principal Investigator, Research Project on **Central Bank Communication Design**, 2018-2023, Japan Society for the Promotion of Science, <http://www.centralbank.e.u-tokyo.ac.jp/>
- Principal Investigator, Research Project on **Chronic Deflation in Japan: Causes, Consequences, and Welfare Implications**, 2023-2028, Japan Society for the Promotion of Science

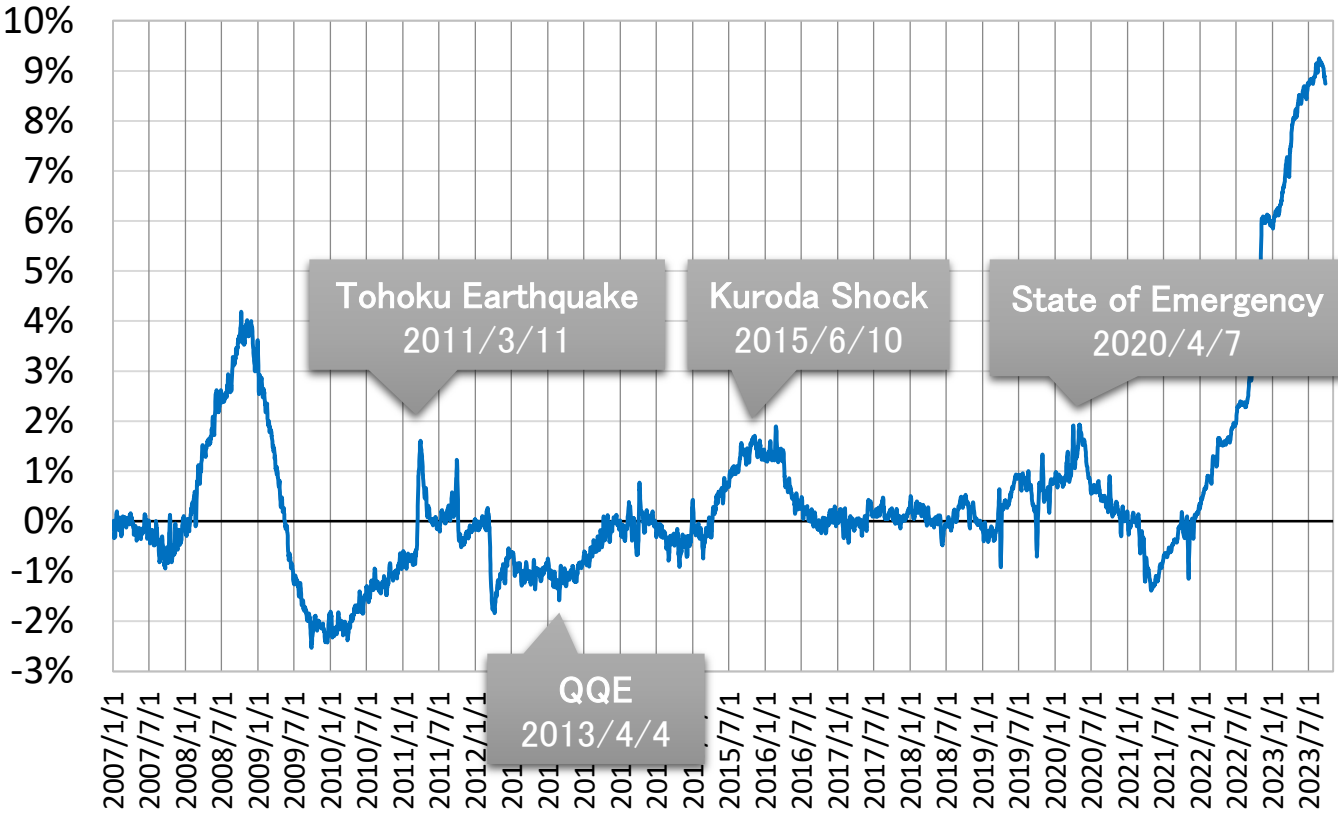
“There are four kinds of countries in the world:
developed countries, undeveloped countries,
Japan and Argentina”

Simon Kuznets

CPI Inflation in Japan and US

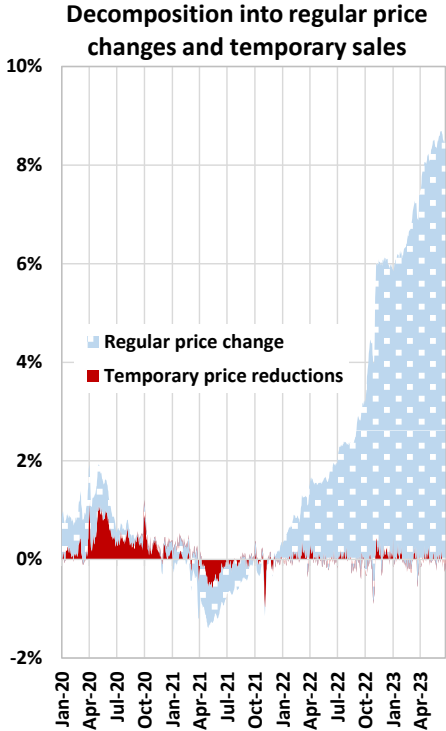


Nikkei CPINow®

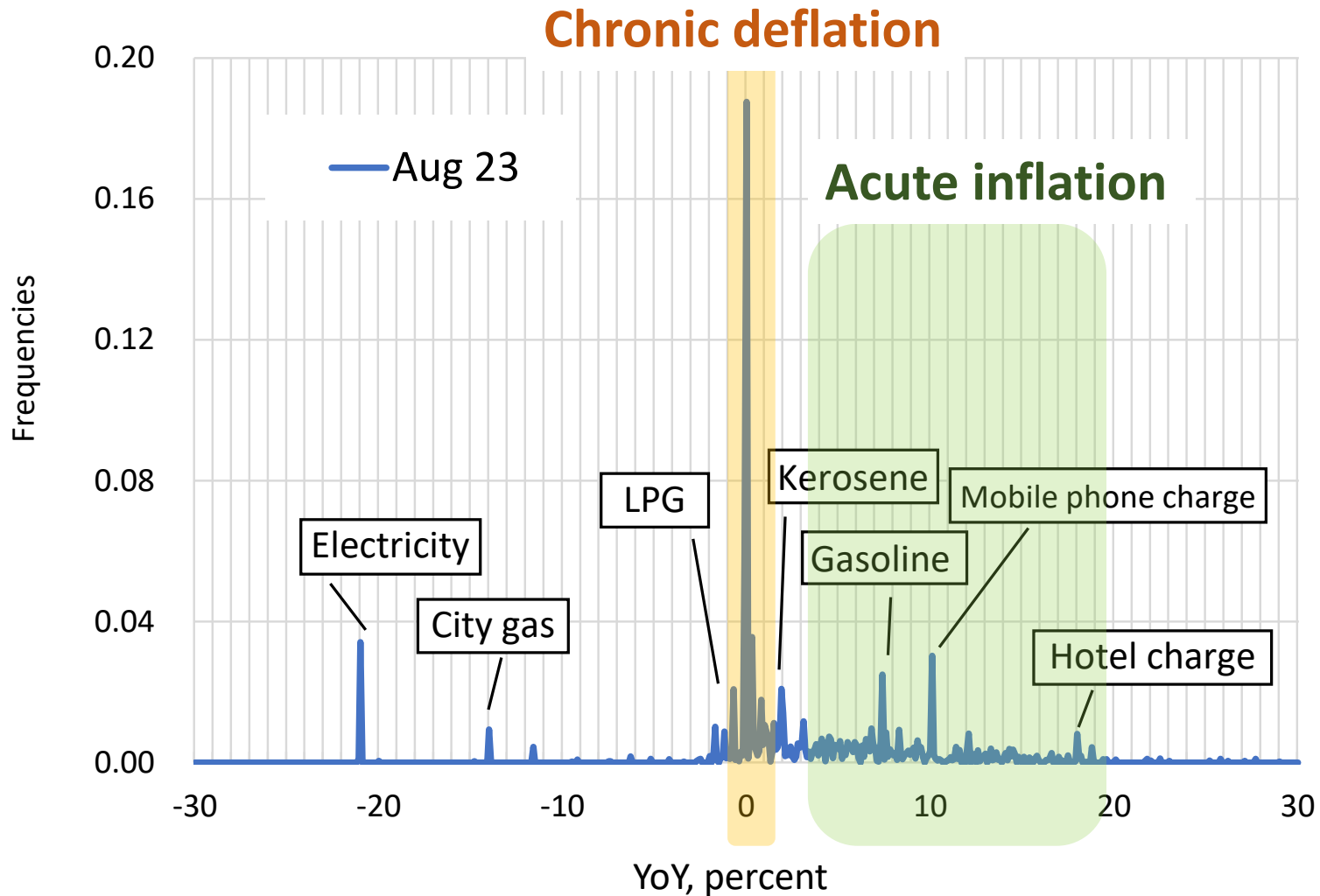


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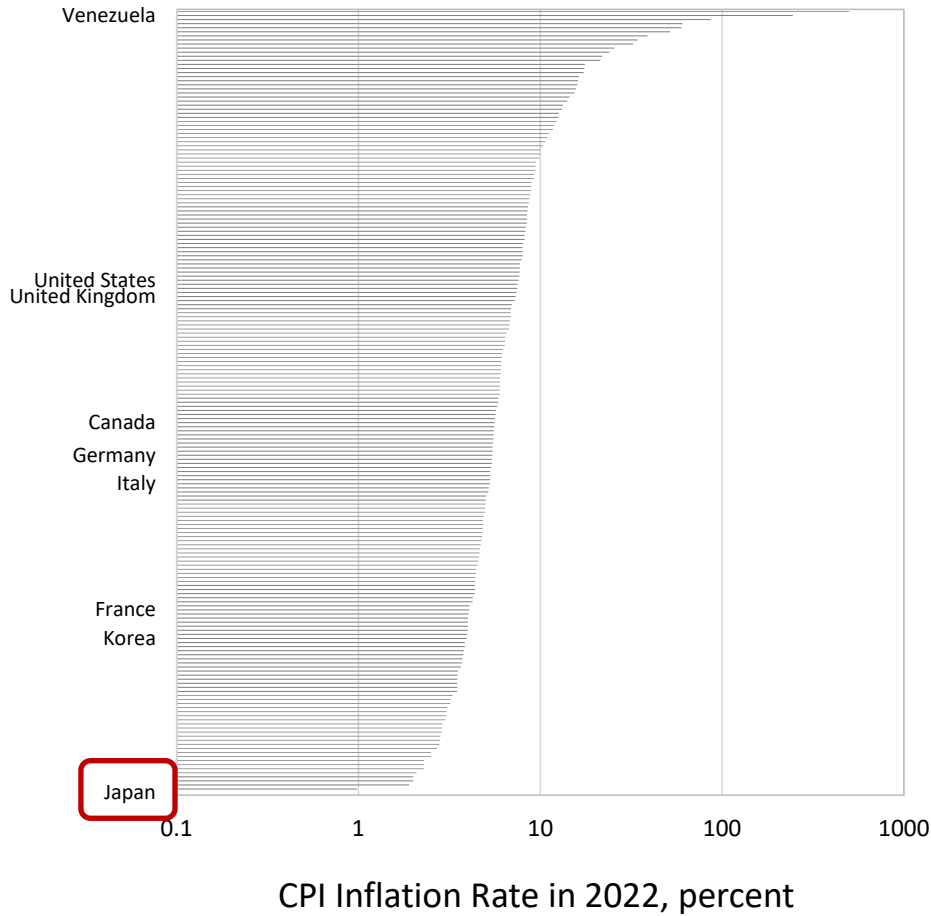


Simultaneous occurring of deflation and inflation

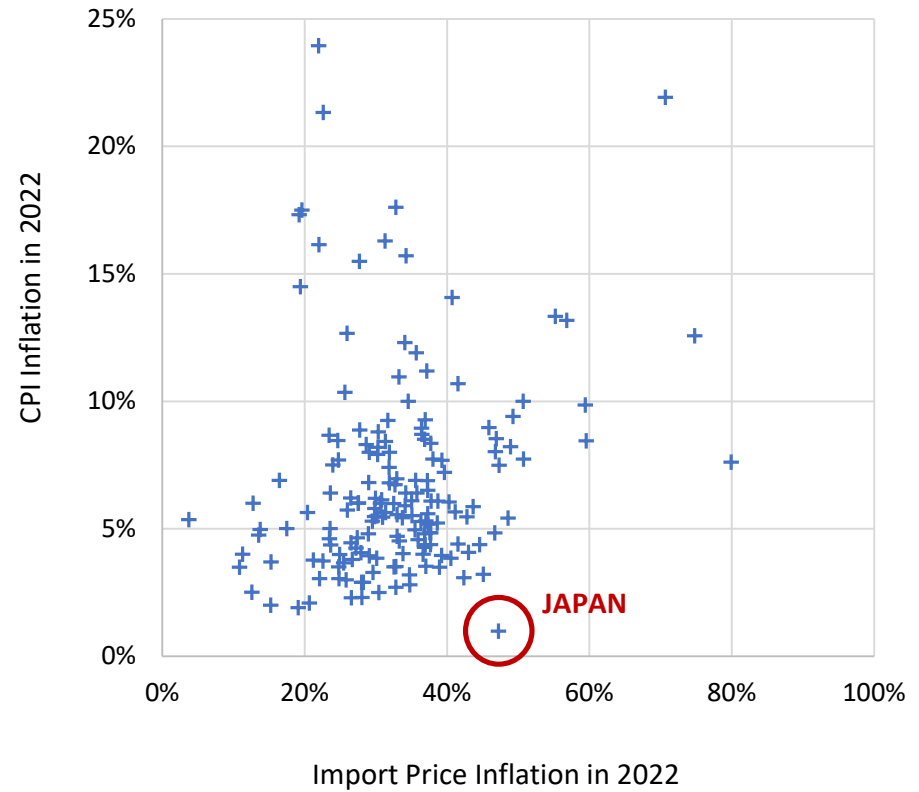


Japan's Chronic Deflation (1)

Consumer Price Inflation by Country 2022

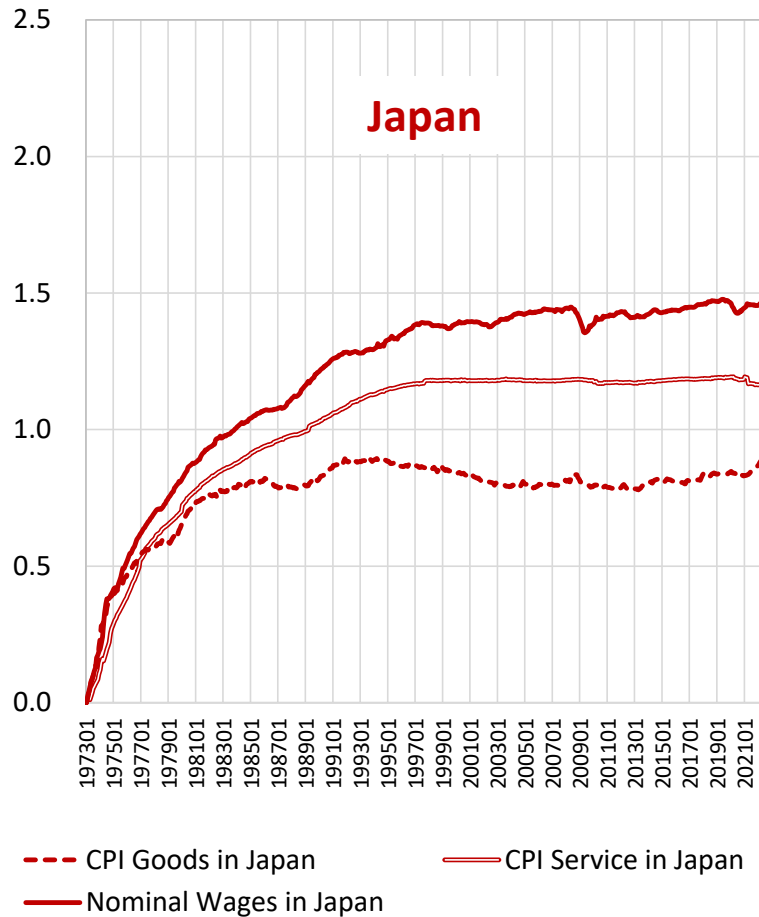


Import Price Inflation vs. CPI Inflation

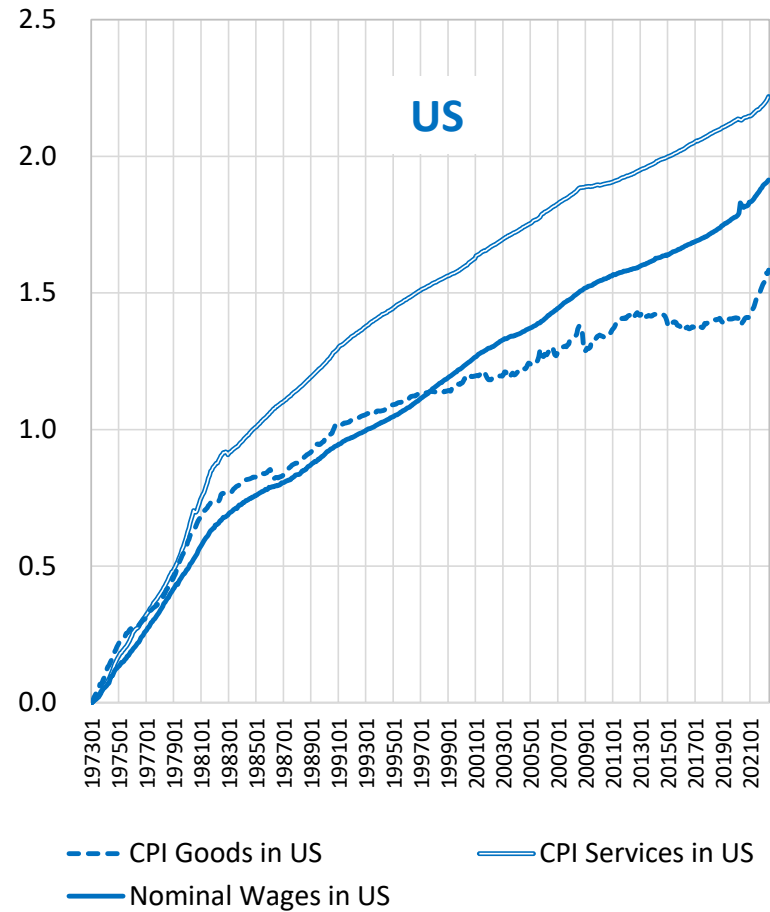


Japan's Chronic Deflation (2)

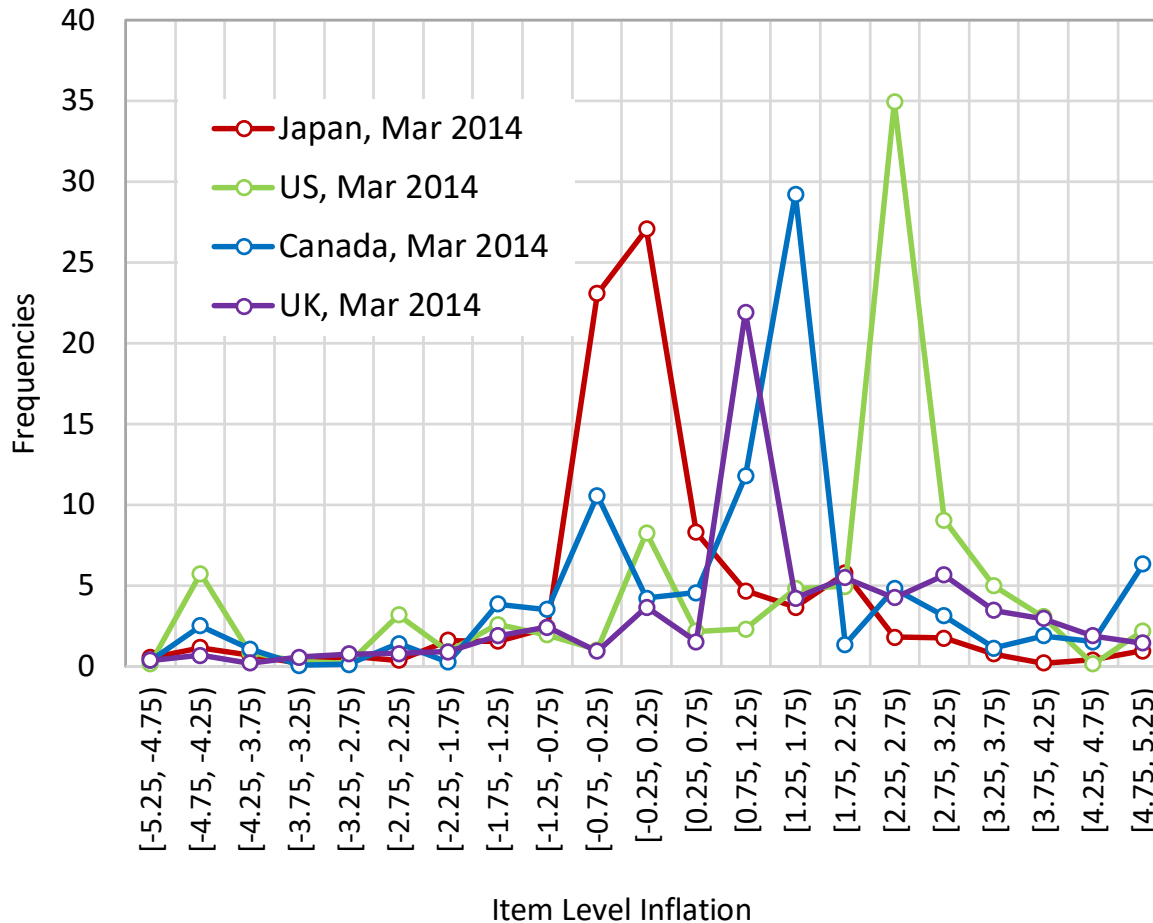
CPI Goods, CPI Services, and Wages



CPI Goods, CPI Services, and Wages

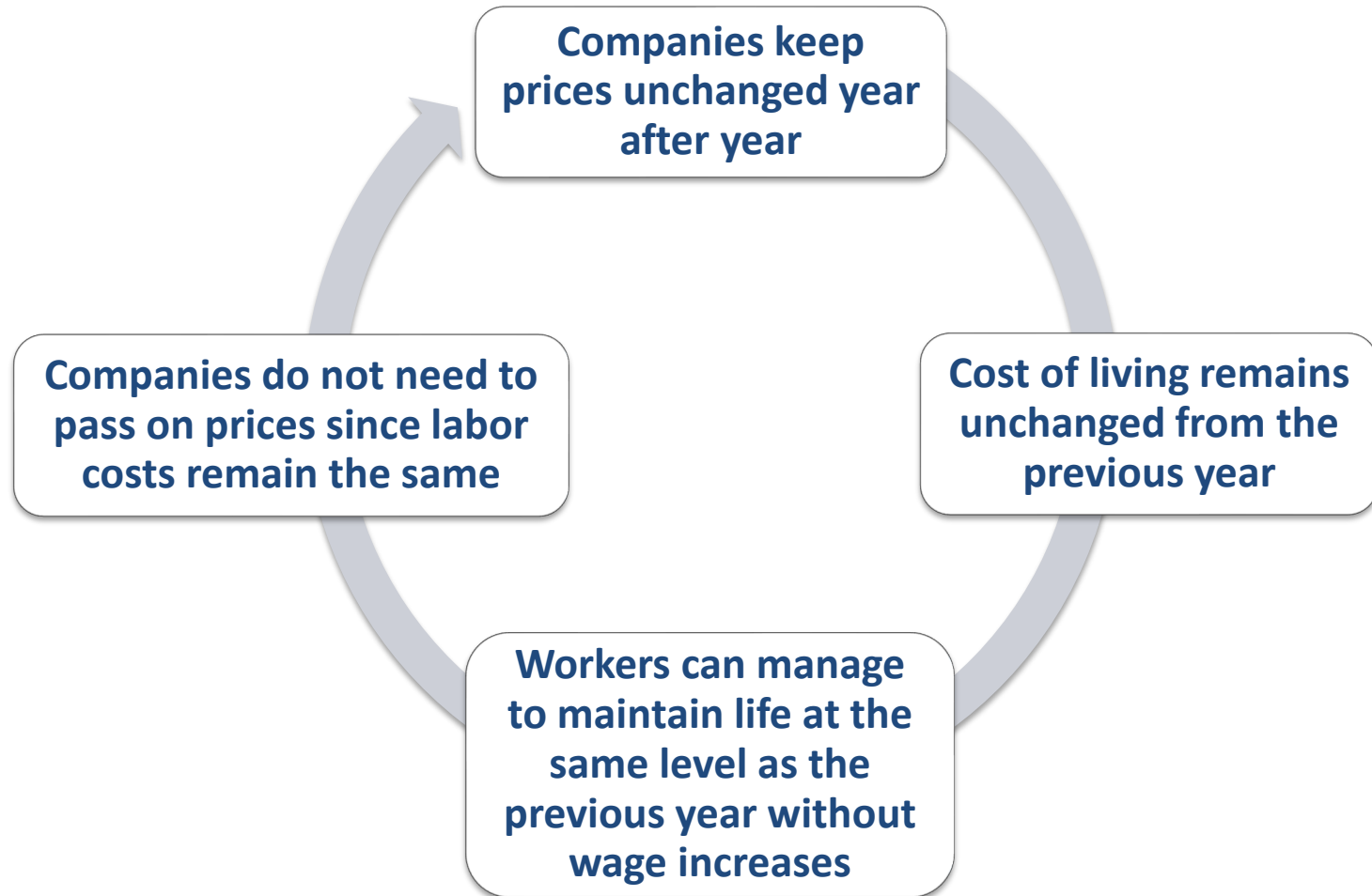


Item-level inflation in various countries



Source: Kota Watanabe, Tsutomu Watanabe, "Why Has Japan Failed to Escape from Deflation?" Asian Economic Policy Review, Vol. 13, No, 1, Jan 2018, 23-41

Japan's Version of Wage-Price Spiral

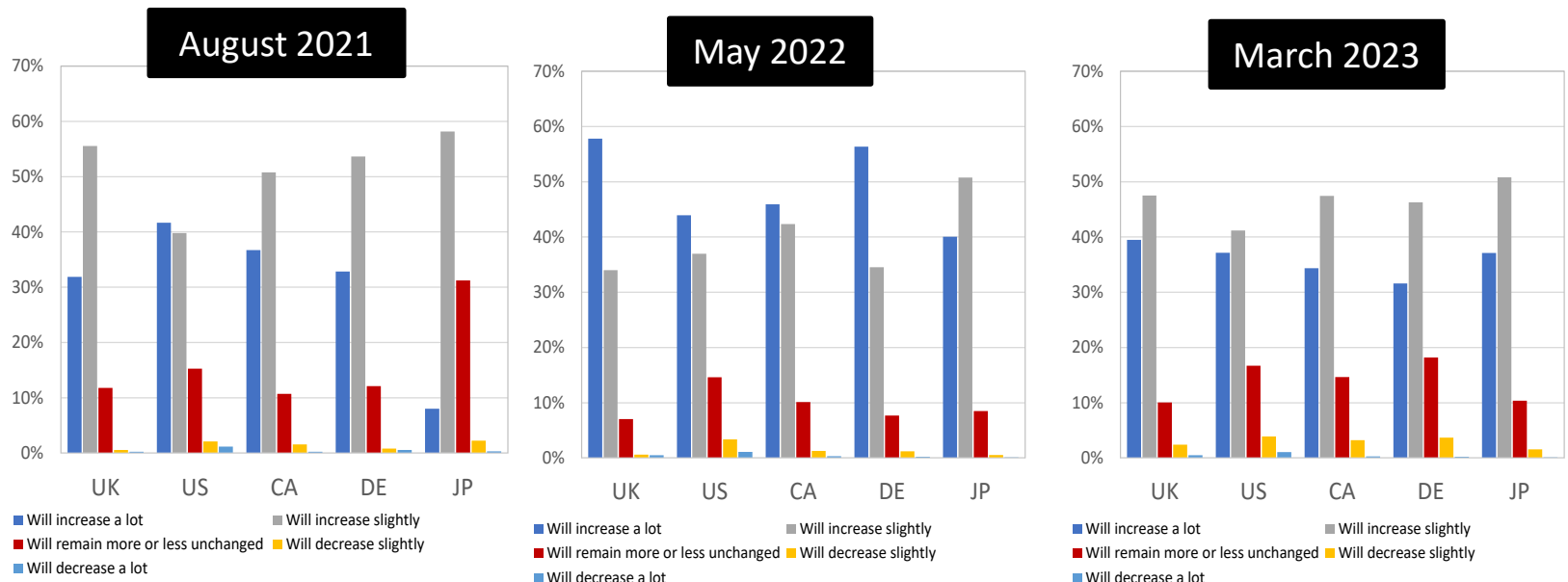


Notable changes in price/wage dynamics since Spring 2022

- 1. Increase in consumers' inflation expectations**
- 2. Improved consumers' tolerance for price increases**
 - In the past, Japanese consumers switched to a different store when they encountered a price increase at a store. They did so because they had a strong belief that prices would remain unchanged in the other stores.
 - However, Japanese consumers no longer flee the store even when prices are raised.
- 3. Increased cost pass-through to prices by companies**
- 4. Increased demand for higher wages from workers**

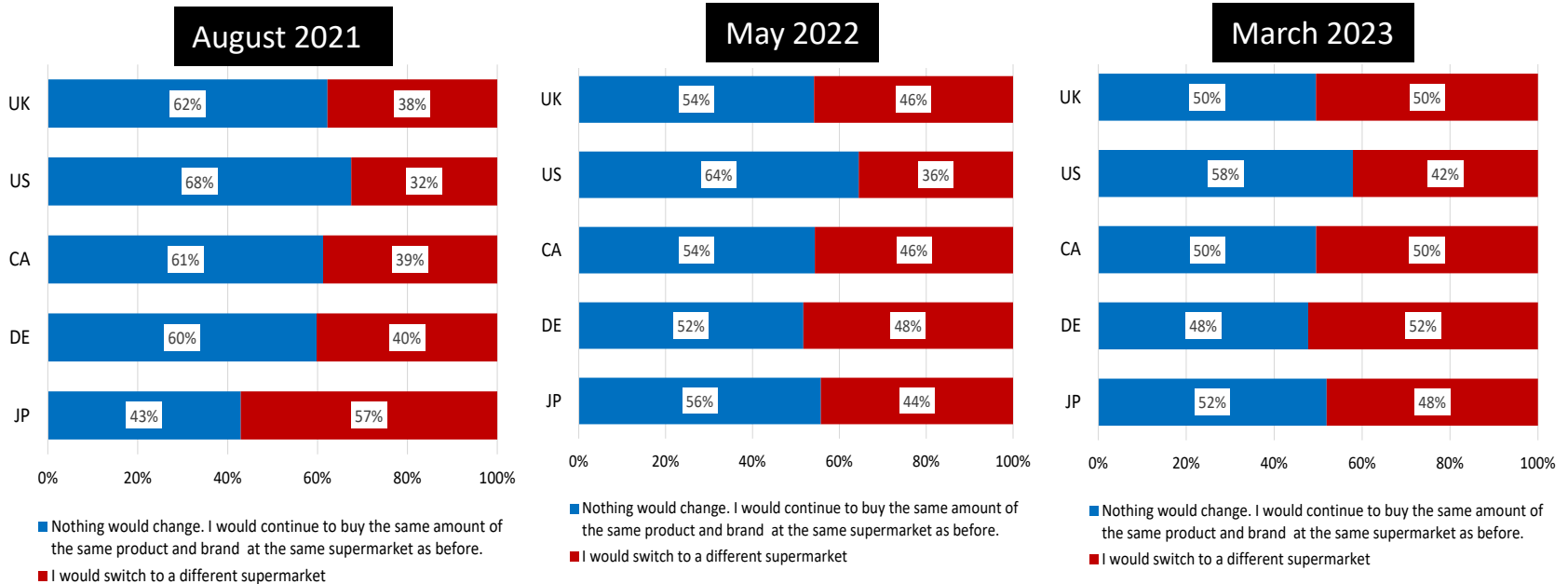
Recent Change #1: Consumers' Inflation Expectations

What do you think will happen to prices over the next year compared to today?



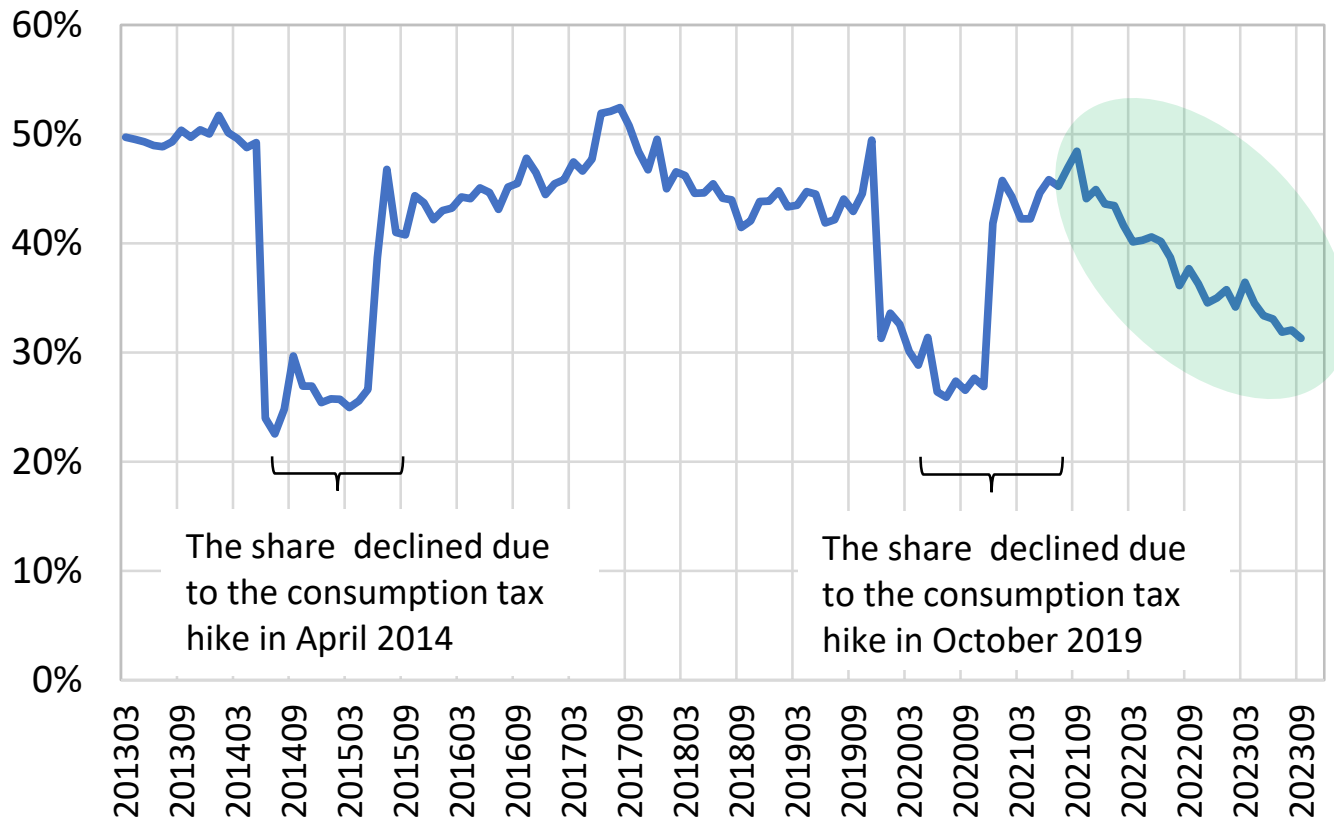
Recent Change #2: Consumers' Tolerance to Price Increases

Suppose that the price of a product that you always buy in your supermarket goes up by 10%. What would you do?



Recent Change #3: Cost Pass-Through to Prices

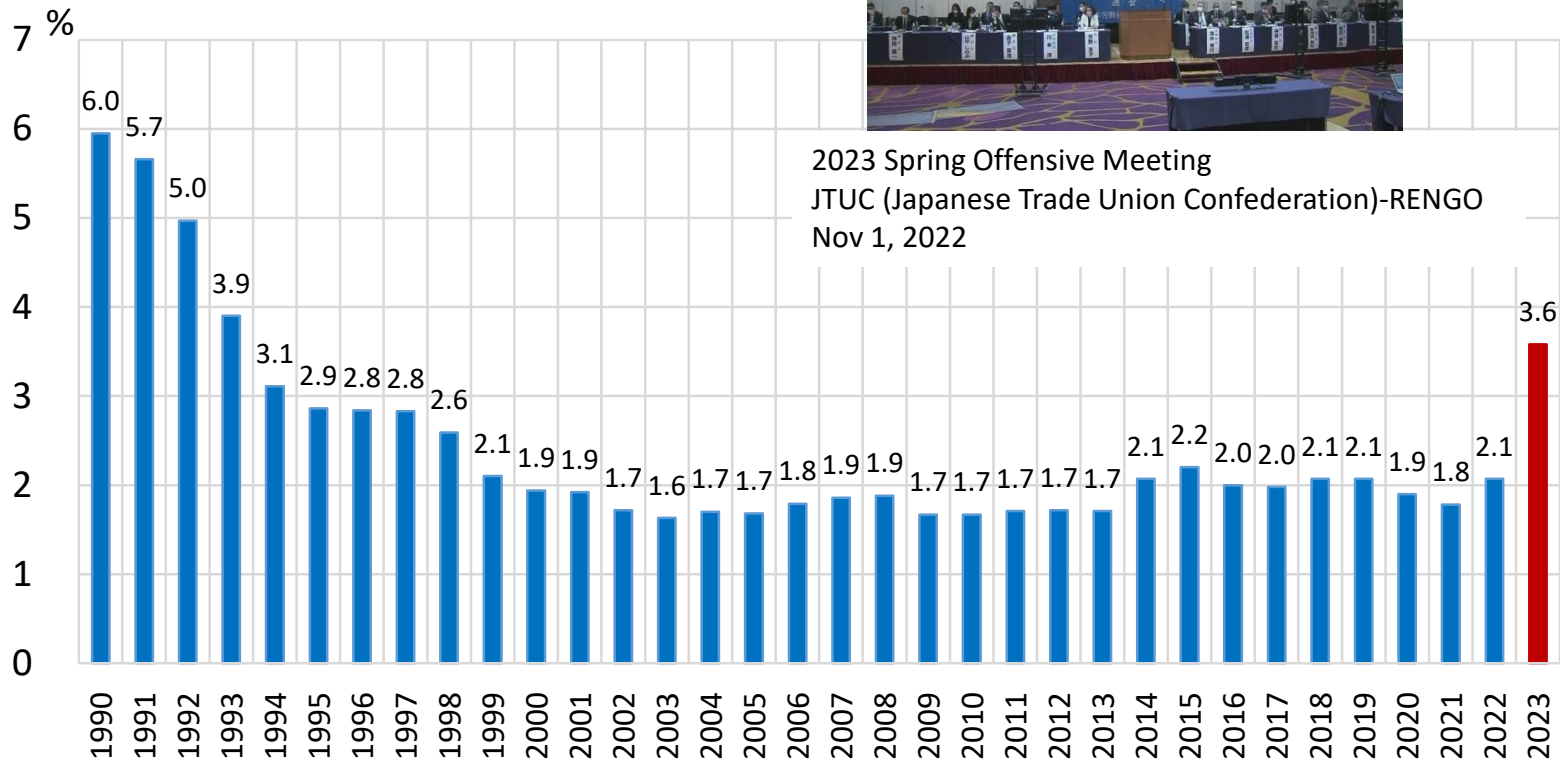
Share of CPI items with near-zero inflation rates



Recent Change #4: Wage Increases in Spring Wage Offensive



2023 Spring Offensive Meeting
JTUC (Japanese Trade Union Confederation)-RENGO
Nov 1, 2022



Note: Wage increase is defined as the sum of (1) Base salary increase and (2) Wage increase along the wage curve.

Chronic Deflation Equilibrium



Equilibrium with Sustained Wage and Price Increases

Companies keep prices unchanged year after year

Companies do not need to pass on prices since labor costs remain the same

Cost of living remains unchanged from the previous year

Workers can manage to maintain life at the same level as the previous year without wage increases

Companies raise prices by 2% every year

Companies pass labor cost increases on to prices

Cost of living increases by 2% every year

Workers demand 3% wage increase (= inflation + labor productivity growth) every year

In the current economic setting, businesses sense that they have lost pricing power and generally have been unwilling to raise wages any faster than they can support at current price levels. **Firms have evidently concluded that if they try to increase their prices, their competitors will not follow, and they will lose market share and profits.** Given the loss of pricing power, it is not surprising that individual employers resist pay increases.

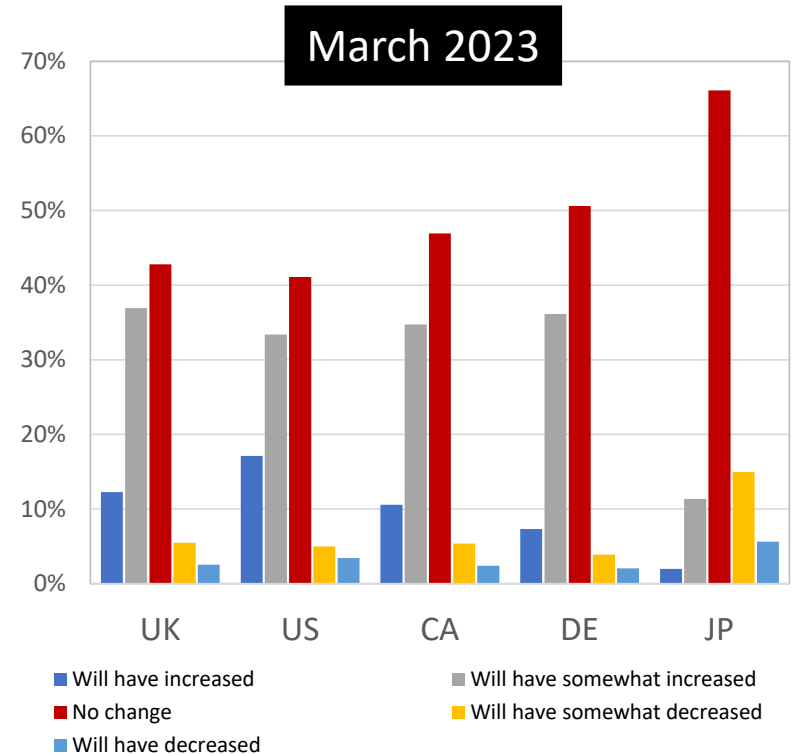
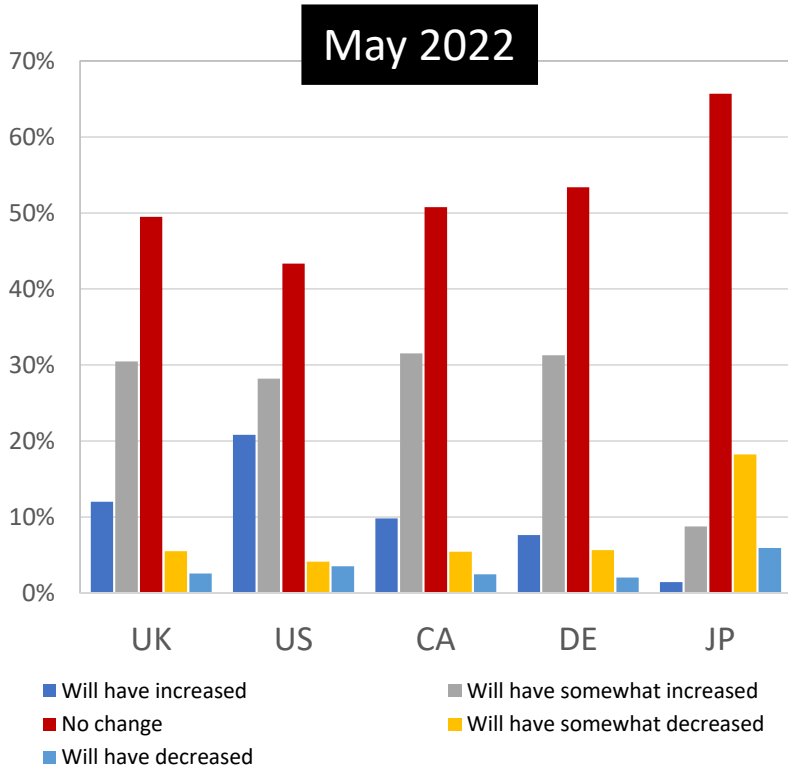
Testimony of Chairman Alan Greenspan, Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 23, 1999

Because neither business firms nor their competitors can currently count any longer on a general inflationary tendency to validate decisions to raise their own prices, **each company feels compelled to concentrate on efforts to hold down costs.** ... This contrasts with our experiences through the 1970s and 1980s, when firms apparently found it easier and more profitable to seek relief from rising nominal labor costs through price increases than through cost-reducing capital investments.

Testimony of Chairman Alan Greenspan, Before the Joint Economic Committee, U.S. Congress, June 14, 1999

	Team Transitory	Team Persistent
The source of ongoing high inflation	<ul style="list-style-type: none"> • Cost-push inflation with foreign origins 	<ul style="list-style-type: none"> • The driving force is consumers high inflation expectations since spring 2022 • Consumers' tolerance for price increases has improved • Firms have started to pass through cost increases to prices
How long will high inflation continue?	<ul style="list-style-type: none"> • CPI inflation will fall to below 2 percent by the end of FY2023 	<ul style="list-style-type: none"> • Consumers inflation expectations will remain well anchored • Firms will continue cost pass through to prices • CPI inflation will continue to stay above 2 percent in 2023 and 2024
What will happen to <i>Shunto</i> in 2024?	<ul style="list-style-type: none"> • The rate of wage increases for SMEs will be much lower in 2024 than this year 	<ul style="list-style-type: none"> • The rate of wage increases for SMEs in 2024 will be as high as this year
Any change in the social norms about wages and prices?	NO: Japan will return to the chronic deflation equilibrium	YES: Japan will switch to a new equilibrium and achieve a virtuous cycle between wages and prices
Who support which?	BOJ, most economists, and Nikkei	Myself, some economists, IMF economists, and Gov Ueda (?)

What do you think your income (e.g., salary) will be in one year's time?



BOJ's "Statement on Monetary Policy"

April 28, 2023

With extremely high uncertainties surrounding economies and financial markets at home and abroad, the Bank will patiently continue with monetary easing while nimbly responding to developments in economic activity and prices as well as financial conditions. By doing so, it will aim to achieve the price stability target of 2 percent in a sustainable and stable manner, **accompanied by wage increases.**

ECONOMY

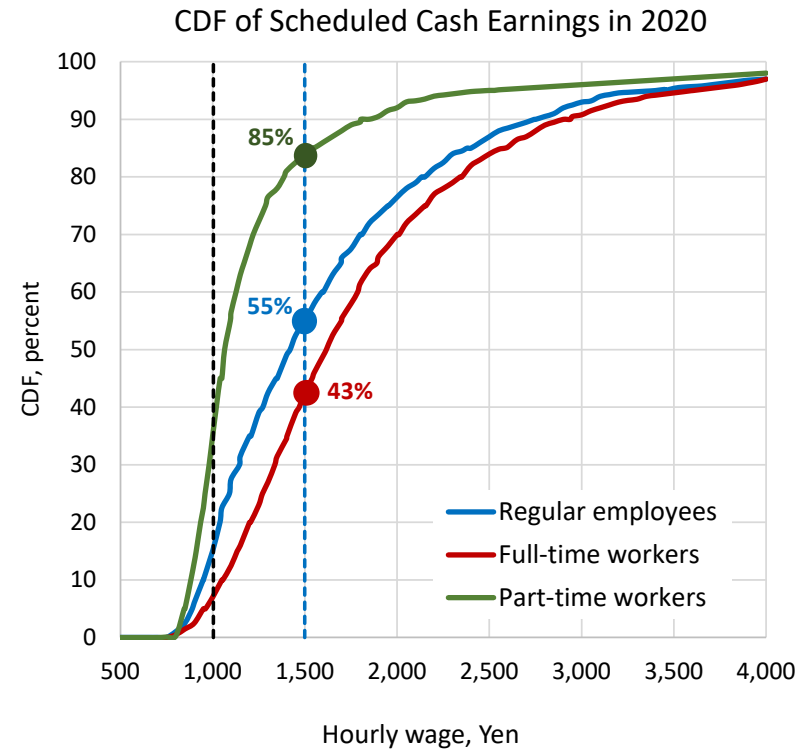
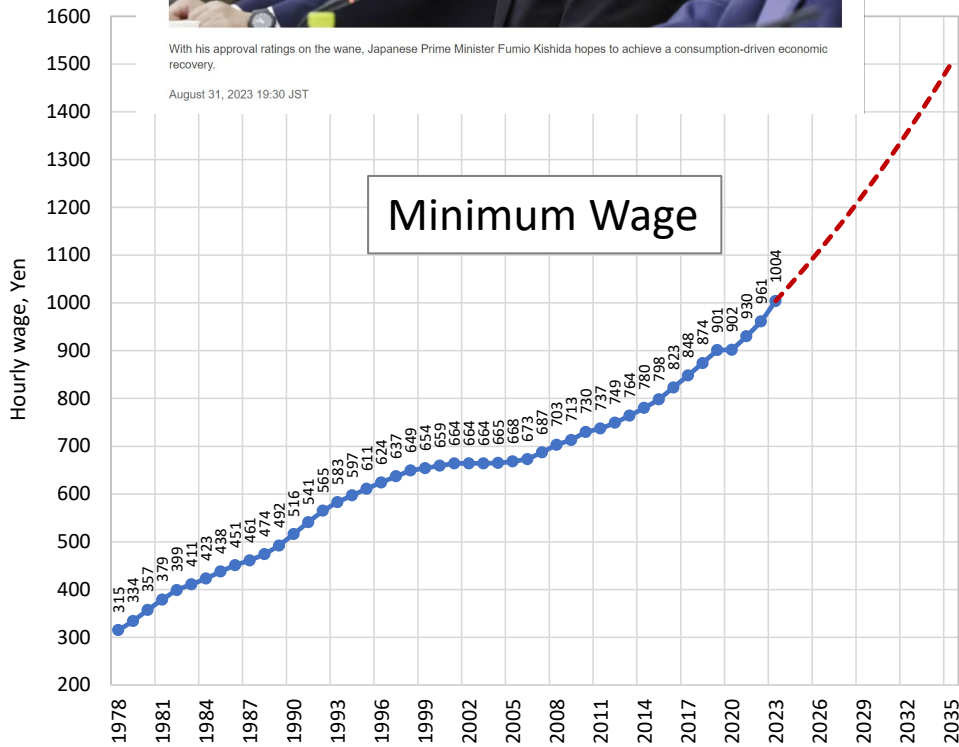
Japan PM Kishida sets a \$10 minimum wage target

Increase from today's less than \$7 an hour is a decade away



With his approval ratings on the wane, Japanese Prime Minister Fumio Kishida hopes to achieve a consumption-driven economic recovery.

August 31, 2023 19:30 JST



Taylor Rule

$$\begin{aligned} \text{Policy rate} = & \text{Equilibrium real interest rate} \\ & + \text{Actual inflation} \\ & + 0.5 * (\text{Actual inflation} - 2\%) \\ & + 0.5 * \text{Output gap} \end{aligned}$$

Takeaways

1. Japan has lived through a quarter century of chronic deflation, with prices and wages stuck as if frozen in place. In that sense, as Simon Kuznets once said, it was a country of outliers. However, Japan is now moving from a chronic deflation equilibrium to a new equilibrium in which prices and wages rise steadily.
 - Japan currently suffers from two diseases: Chronic deflation and Acute inflation.
 - Important changes have been taking place since the spring of 2022: (1) A rise in consumers' inflation expectations; (2) An increase in consumers' tolerance to price increases; (3) An increase in firms' cost pass-through to prices; (4) Labor unions win highest pay raise in nearly 30 years in 2023 Spring Wage Offensive
2. Inflation is not a transitory phenomenon, as many economists initially thought, but a persistent one. Wage increases in next year's Spring Wage Offensive will be as high as this year's or even higher.
3. BOJ will likely decide to raise its policy rate early next year, given that price stability and stable wage growth have been achieved. After that, however, BOJ will take time to assess the impact of the policy rate hike on prices and wages. Repeated policy rate hikes are unlikely during 2024.