Yen Issues

Overview

- Japanese inflation is now at a multi-decade high. But it remains much lower than other major economies, and underlying inflation remains inconsistent with the BoJ's target.
- The causes are numerous, including cyclical weakness, subdued wage and price expectations, poor demographics and low productivity, some sector-specific factors, and geography.

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Japanese headline inflation has risen to multi-decade highs; but underlying inflation remains low

Japanese inflation is stirring. In August, the headline CPI inflation rate rose above expectations, jumping 0.4ppt to 3.0%Y/Y, up 2.5ppts since the start of the year, above the BoJ's 2% target, and the highest since September 2014. When excluding the impact of past consumption tax hikes, CPI inflation was the highest for 31 years. Since June, prices of more than 70% of items have risen over the previous twelve months, the highest share on the series dating back more than two decades. But Japanese headline inflation is still well below levels in other major economies (e.g. CPI inflation in August was 8.3%Y/Y in the US, and above 9%Y/Y in the euro area and UK). Underlying inflation remains much softer too. For example, excluding all energy and food prices – which, as elsewhere, have risen rapidly – core CPI inflation rose in August to 0.7%Y/Y, the highest since 2015, but still less than half the BoJ's target. And the weighted median CPI rate in the latest month was just 0.5%Y/Y. As a result, based on its most recent inflation projections published in July, despite recent yen weakness, the BoJ still expected inflation to fall back below the 2% target next fiscal year and remain below-target at 1.1-1.5%Y/Y in FY24.

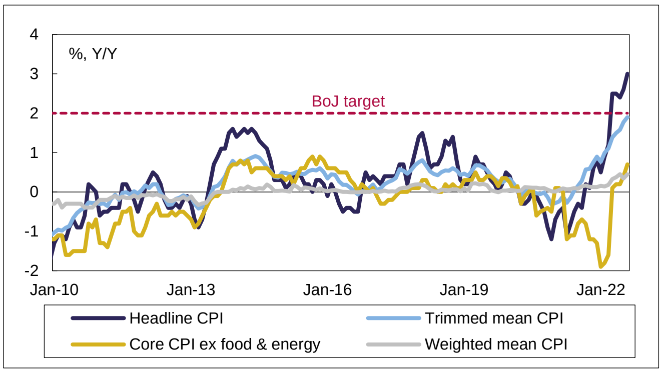
So why is Japanese inflation still so weak?

Cyclical factors – a lagging recovery. Japan's economic recovery from Covid-19 continues to lag that of the other large industrial economies. Japanese GDP only rose above the Q419 pre-pandemic level in Q222, four quarters after the US and two quarters after the euro area passed the same threshold. And Japanese GDP remains about 2½% below the pre-pandemic peak in Q319 ahead of the last consumption tax hike. Among other things, Japan's recovery has lagged the other major economies due to a slower pace of easing of pandemic-related restrictions, not least in the hospitality and tourism sector. The impact of continued local lockdowns in China has also slowed the recovery in the manufacturing sector. So, unlike the US in particular, domestic demand-driven price pressures have yet to emerge. And unlike Europe, rebounds in prices in various services associated with post-pandemic reopening remain modest. The reopening of Japan's borders and government plans to support recovery in hospitality and tourism offers scope for stronger economic activity over coming quarters. But Japan's economy won't be immune to recession in the US and Europe, a concern flagged by the BoJ today.

The "deflation mindset" #1 – low inflation expectations. BoJ Governor Kuroda has long referred to Japan's "deflation mindset", whereby inflation expectations had been scarred by the experience of more than two decades of, on average, mild deflation ahead of the pandemic. That meant that firms were typically reluctant to raise prices, letting their margins absorb the hit from cost pressures. And it also meant that workers often saw little need, or were simply reluctant, to press for wage increases. Eight years after the launch of Abenomics, however, there is evidence that firms are now more willing and able to increase their own prices. And the BoJ's Tankan survey suggests that, while firms still expect their own prices on average to rise by less than 2% a year over the medium term, they expect general inflation to rise broadly in line with the target over the coming three and five years. In contrast, however, financial market inflation expectation measures (e.g. 5Y5Y inflation forward swaps or break-even rates on JGBi's) are typically less than half levels consistent with the BoJ's target.

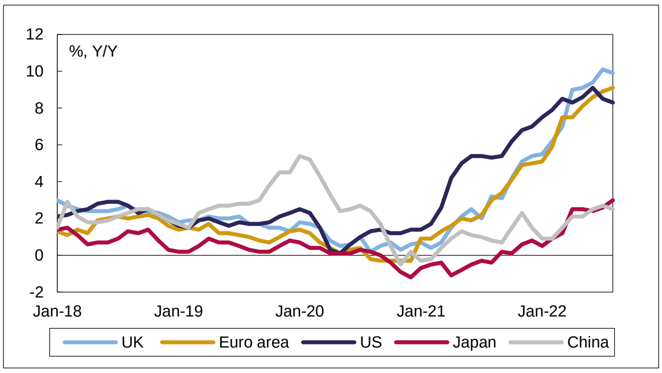
The "deflation mindset" #2 – low wage growth. While the labour market is tight, and wage growth has picked up (regular pay in July rose 1.2%Y/Y, the second-fastest pace for 25 years), it also remains below levels consistent with the inflation target. That might reflect, among other things, Japan's consensual society, and a greater weight placed by unions on job security than real incomes.

Japan: Consumer price inflation*



*Excluding impact of consumption tax hikes. Source: Refinitiv, BoJ and Daiwa Capital Markets Europe Ltd.

Major economies: Consumer price inflation



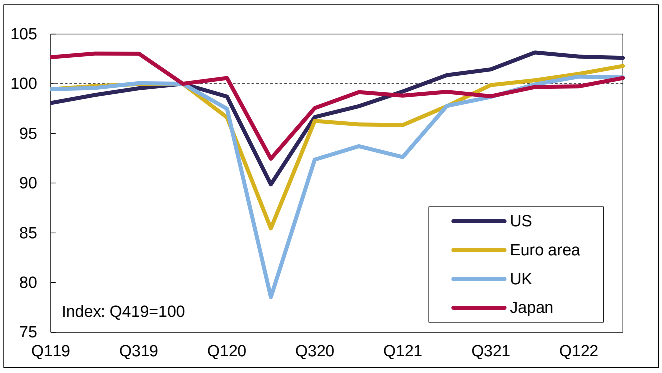
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Adverse demographics & low potential growth. Japan's adverse demographics might contribute to low inflation expectations, being associated among other things with risk aversion, low potential growth and disincentives to invest in certain sectors. Low wage growth can also reflect subdued trend productivity growth. By the same token, therefore, adverse demographics might also be consistent with a very low "neutral" real interest rate, which might suggest that BoJ policy is not as accommodative as it appears at first glance.

Sector-specific factors. Special characteristics of certain sectors also continue to weigh on inflation. For example, government efforts to lower mobile phone charges meant that those prices continue to be well down on a year ago (falling 14.4%Y/Y in August, albeit less marked than the drop of more than 40%Y/Y a year earlier). Housing rents are little changed from two decades ago in Japan contrasting markedly their equivalents in other major economies. In addition, the share of energy in the CPI basket – which has seen the largest price pressures in recent quarters – is smaller in Japan than in the US, euro area and UK. And Japan has also not been as exposed to the Russia-related energy price pressures as Europe.

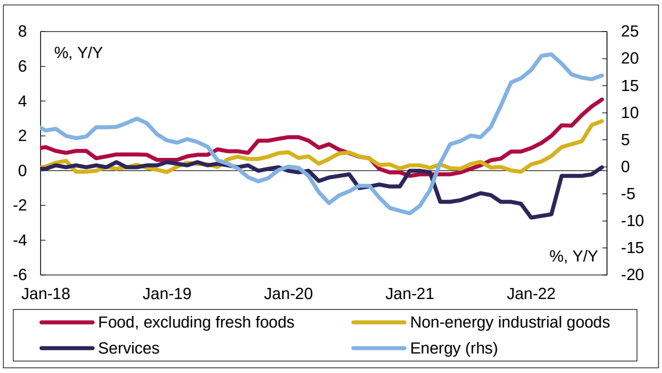
Geography. Japan's proximity to and greater economic integration with China arguably acts as a larger restraint on price pressures than in the US and Europe. Certainly, being located close to China meant that cost pressures associated with supply-chain disruption and shipping freight capacity constraints were not as acute as in the US and Europe during the initial post-pandemic reopening phase.

Major economies: GDP levels



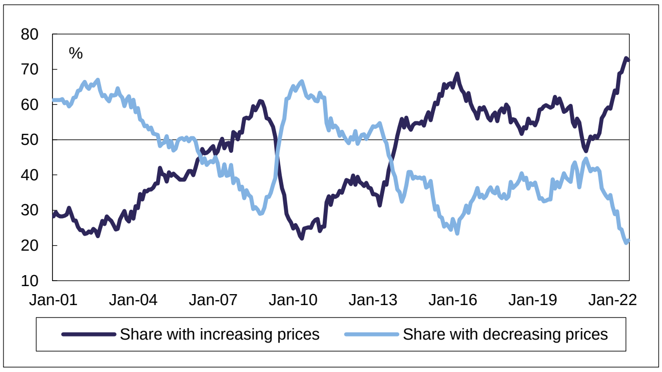
Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Japan: Selected CPI components



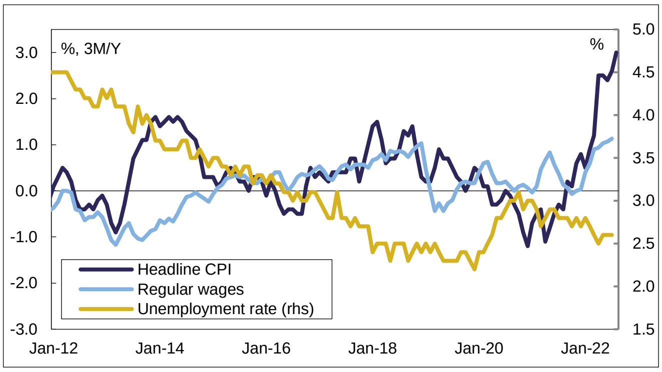
Source: Refinitv, BoJ and Daiwa Capital Markets Europe Ltd.

Japan: Share of CPI basket with rising/falling prices



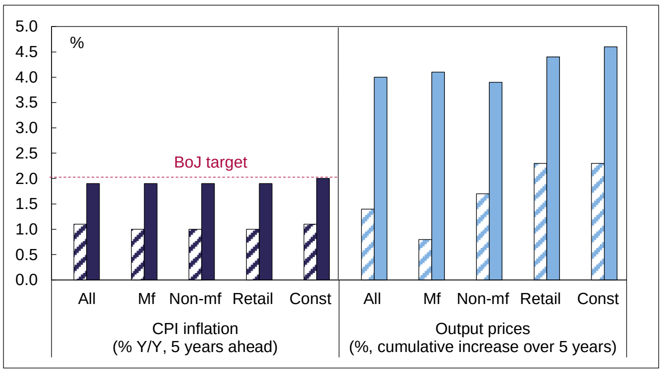
Source: BoJ and Daiwa Capital Markets Europe Ltd.

Japan: CPI, wage growth & unemployment



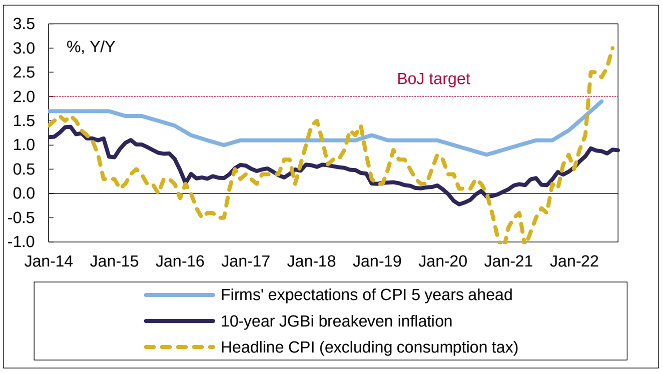
Source: Refinitiv, MIC and Daiwa Capital Markets Europe Ltd.

Japan: Firms' price expectations*



**Bars with dashed lines represents Q419. Solid bars represent Q222.*
Source: Refinitiv, BoJ and Daiwa Capital Markets Europe Ltd.

Japan: CPI & price expectations



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

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