Daiwa's View

Japanese inflation and public intervention: Policy-induced distortions and divergence in perceptions of inflation

- Costs and distortions of price controls are becoming evident in interest rates and forex rates

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Core CPI excluding institutional factors: Inflation is already strong, but observations are fragmented

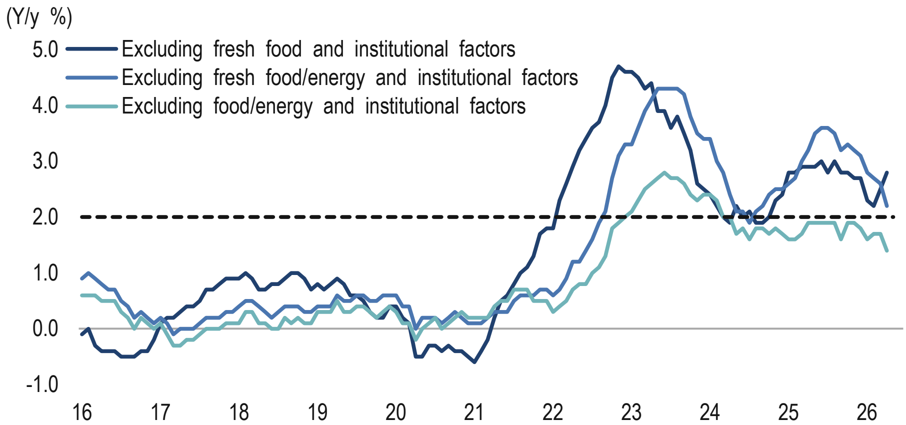
The BOJ's "core CPI excluding institutional factors" for April rose 2.8% y/y, accelerating from +2.5% in the previous month. This indicator excludes not only fresh food but also policy-related factors such as subsidies and tax changes, and has remained above 2% for 19 consecutive months.

By contrast, the standard core CPI compiled by the Ministry of Internal Affairs and Communications (MIC) rose only 1.4% y/y, with the apparent inflation rate being substantially depressed by the impact of government gasoline subsidies and support measures for electricity and gas bills.

Looking at underlying inflation indicators, the core-core CPI excluding fresh food, energy, and institutional factors rose 2.2% y/y, but decelerated from the previous month, while the reading excluding food and energy rose only 1.4% y/y. Distribution-based indicators such as the trimmed mean, weighted median, and mode all declined m/m.

As a result, Japan's inflation has a multilayered structure—indicators including policy factors appear low, those excluding policy factors look strong, and the underlying trend based on distribution measures is showing a slight slowdown. It remains difficult to grasp the underlying inflation trend from any single indicator. Inflation is being distorted by policy measures, and the observation of inflation itself has become fragmented.

CPI Readings Excluding Institutional Factors



Source: BOJ; compiled by Daiwa.

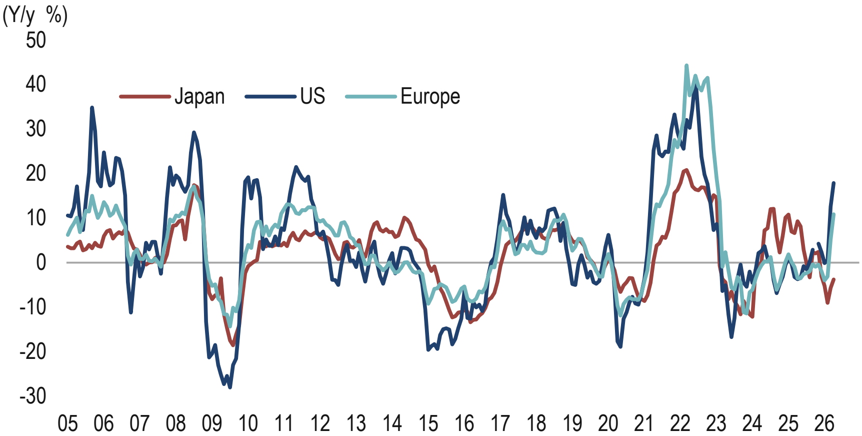
Public intervention as price controls: Structure of suppressed inflation

As background to these inflation distortions, Professor Kenichi Ueda's *Nikkei Economics Classroom* column in October 2024 positioned the government's broad-based intervention in prices and corporate activities as a structural issue for Japan.

Although Japan is highly dependent on overseas sources for energy and food, consumer prices have been suppressed compared with the US and Europe. This has not been the result of monetary tightening, but rather reflects the fact that food prices such as rice, wheat, and milk, as well as energy-related prices such as electricity and railway fares, are publicly controlled. In addition, subsidies for gasoline and other items have been used to restrain price fluctuations.

Under this structure, the price adjustment through market mechanisms has been partially replaced by policy, resulting in a situation in which inflation is suppressed through channels other than monetary policy. It can be understood that this policy-led price stability was a key reason the BOJ was able to maintain its easing policy for an extended period compared with the US and Europe.

Energy Price Trends in Japan, US, and Europe (y/y)



Source: MIC, US Department of Labor, Eurostat; compiled by Daiwa.

Linkages with fiscal and monetary policy: Costs of price controls and spillovers to markets

However, such price controls entail large-scale fiscal spending. Subsidies and price-suppression measures have expanded the fiscal deficit, which has been financed through JGB issuance, while the BOJ has absorbed these bonds as part of its monetary easing. Although this structure operates through the secondary market, it could effectively be interpreted as fiscal financing, distorting the relationship between fiscal and monetary policy roles that should, in principle, be separate.

As the BOJ enters the process of normalizing interest rates, these distortions are becoming increasingly apparent. Price-adjustment pressures that had previously been suppressed are beginning to be transferred to market prices such as long-term interest rates and forex rates.

Regarding the divergence between inflation and forex rates, Professor Ueda offered an explanation in another *Nikkei Economics Classroom* column in October 2023 through the lens of market participants' expectation formation. Normally, if prices are stable, real interest rates are relatively high even when nominal interest rates are low, making yen depreciation less likely.

In practice, however, the yen has depreciated substantially. One possible reason is that markets may recognize that price distortions caused by subsidies and other measures are not sustainable, and may expect inflation to return to a higher level in the future. In that case, real interest rates are judged to be low, and the currency's value adjusts to roughly the same extent as the nominal interest rate differential, resulting in yen depreciation. Here, exchange-rate formation is reflecting not the observed inflation rate itself but the market's judgment regarding its sustainability.

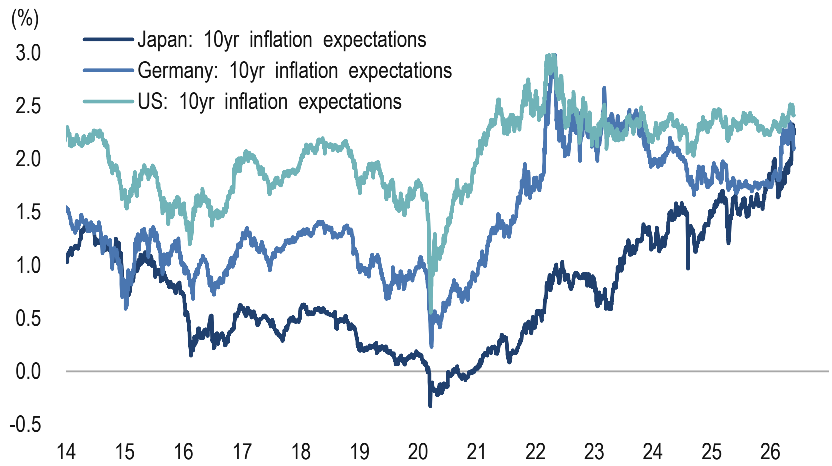
Former BOJ Governor Masaaki Shirakawa states in his recent book, *Imprinting Credibility on Currency* (our translation), that "the stability of currency and the financial system ultimately depends on confidence in fiscal sustainability."

Structure in which inflation expectations do not decline even amid lower crude oil prices

A similar structure is beginning to appear in market inflation expectations. Even as crude oil prices have recently declined, Japan's inflation expectations have been slow to fall, with the extent of the decline remaining limited compared with Europe and other regions.

Behind this is thought to be concern over whether policy-driven price suppression is sustainable. In other words, the structure is such that even if currently observed inflation is suppressed, it is recognized that future inflation will remain high as long as this suppression relies on temporary measures. As a result, in Japan, assessments of policy sustainability are playing an increasingly important role in shaping inflation expectations, relative to actual inflation developments.

10yr BEI in Japan, US, and Germany



Source: Bloomberg; compiled by Daiwa.

Against this backdrop, BOJ Deputy Governor Ryozo Himino also stated in the Diet yesterday that "it is important to secure market confidence that inflation will be appropriately controlled." While referring to the possibility that heightened inflation concerns may be leading to higher long-term interest rates, he indicated the need to maintain confidence through adjustments to monetary policy.

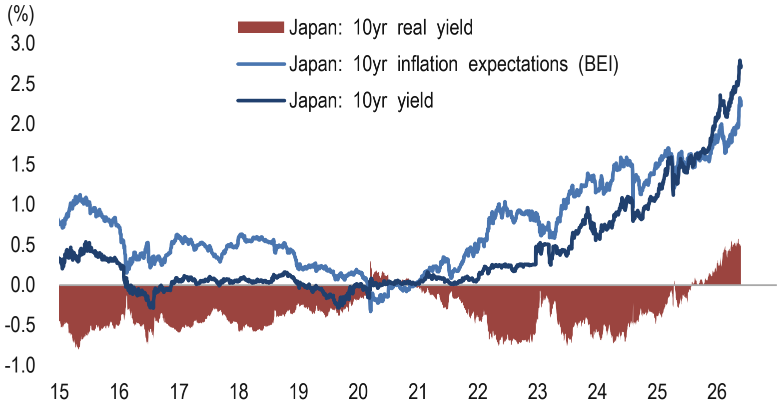
In addition, based on the view that real interest rates remain at extremely low levels, he also indicated a policy stance of raising the policy rate in response to developments in economic activity and prices. The key focus here is not the price level itself, but rather market confidence in the consistency between inflation and policy operations.

Conclusion: Markets are pricing in policy-induced distortions

Based on the above, Japan's inflation is being suppressed by policy, but excluding policy factors, it is already running above 2%, and the divergence between observed indicators and the underlying trend is widening. Price controls have been maintained through fiscal spending and the BOJ's balance sheet, but as monetary normalization progresses, these distortions are increasingly becoming evident in interest rates and forex rates.

Markets have already begun to price in future inflation resulting from the unsustainability of policy measures, rather than the currently observed low inflation. In this sense, Japan's inflation can be understood as shifting from a phase in which it is stabilized by policy to one in which it is reassessed through the lens of policy sustainability.

Japan: 10yr Yield, Real Yield, and BEI



Source: Bloomberg; compiled by Daiwa.

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