Rising Japan inflation: a possible shock

Labour tightness will help realise 2% price target

by Akinari Horii in Tokyo

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The world economic and financial scene appears too good to be true. Growth has strengthened. Inflation is subdued. Financial markets demonstrate rich valuations and low volatility. Extraordinary monetary easing and expansionary fiscal policy have eased balance sheet pressures stemming from the 2008 financial crisis. Yet abnormally high liquidity has built up on financial markets, together with a debt overhang from excessive borrowing by governments in many advanced countries and corporates in emerging economies.

Some adjustment to these decade-long excesses is inevitable, potentially setting off a market shock. One possible trigger largely dismissed by financial markets is a resurgence in inflation, particularly in Japan. The annual rise in Japanese consumer prices is running below 1%, despite the low unemployment rate of 2.8%. Japanese inflation expectations are anchored around zero, against 2% in the US and 1% in the euro area. However, as early as autumn/winter 2018, Japanese inflation could reach the long-targeted level of 2%, reflecting the tightest labour market in 50 years, higher commodity prices, and a probable late-2018 surge in consumer spending.

Because it has long been considered a most remote possibility, news that 2% inflation is imminent can shake government bond markets not just in Japan but also in the US and Europe.

A mitigating factor is that international monetary authorities, including the Federal Reserve, are normalising policies only gradually. This is partly because of expectations of a shock from other sources such as geopolitics (North Korea), a debt crisis in China, or a technology-driven upheaval (runs on unregulated fintech products or cyber attacks).

Worryingly, markets’ shock-absorbing ability appears to have fallen. Securities and foreign exchange dealers’ market-making capability has declined significantly because of Basel III and Dodd-Frank regulations. Credit risk-taking, restrained in the banking sector, has grown strongly in shadow banking. With the build-up of passive investors and indexed products, a dearth of active managers makes the market prone to herd behaviour, a danger exacerbated by high-frequency trading and other algorithm-based activities.

Against this background, Japanese inflation developments are important. First, thanks to the improved economy, Japan closed its output gap in 2017 and is moving towards supply-side shortages and overheating. Although the deflation mindset has persisted for trade unions and managements, there are signs of change. Freight costs for small package freights have risen. Part-time workers’ pay has increased significantly. Prime Minister Shinzo Abe’s administration is putting pressure on businesses and unions for higher wage increases, which will prove effective in raising wages and consumption in spring 2018.

Second, international commodity prices bottomed in 2017 and will stay firm in 2018. Strong economic growth in the US, supported by President Donald Trump’s fiscal policies, will sustain a firm dollar against the yen.

Third, events surrounding the planned April 2019 abdication of Emperor Akihito, amplifying the traditional coming-of-age ceremonies in mid-2019, will further stimulate consumer demand ahead of the consumption tax rate rise to 10% from 8% in October 2019.

The Bank of Japan will be patient in maintaining its monetary policy framework after the inflation rate reaches 2%. It will err on the easing side rather than embark on premature tightening. Nonetheless, the central bank will adjust the zero-yield target for 10-year government bonds, perhaps up to 0.25%, as US long-term interest rates rise. Alternatively, it may shorten the target maturity from 10 to five years, allowing 10-year yields to go higher.

In Japan, as elsewhere, labour market tightness does in fact lead to inflation. Many commentators have emphasised a breakdown in the traditional Phillips curve of unemployment and inflation, telling us we shouldn’t worry about rising prices. But the Phillips relationship is a curve, not a straight line; there are
inflection points. In Japan, the inflection point appeared on several past occasions when the unemployment rate was below 3%. Anyone who believes that this time is different is displaying not prescience, but myopia.

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