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# Japan in the World

## As Inflation Becomes Domestically Driven, a “Virtuous Cycle Between Wages and Prices” Awaits

January 2024

# Japan in the World

## As Inflation Becomes Domestically Driven, a “Virtuous Cycle Between Wages and Prices” Awaits


| | |
|---|---|
| **Economic activity transitions from reopening to a new equilibrium** | **1** |
| **The differences between Japanese and US inflation: (1) The drivers** | **2** |
| **The differences between Japanese and US inflation: (2) Persistency** | **3** |
| **Japan's inflation is expected to become more sticky, but remain under 2%** | **4** |
| **The quickening pace of wage increases** | **5** |
| **Yield Curve Control (long-term interest rate manipulation) is increasingly ineffectual** | **6** |
| **Widening difference in policy interest rates** | **7** |
| **Pivot expected for US monetary policy** | **8** |
| **The “virtuous cycle between wages and prices” desired by the BoJ** | **9** |
| **The green shoots of additive profits are beginning to appear** | **10** |
| **Five alarm bells are ringing in Japan** | **11** |
| **Labor mobility** | **12** |
| **What can be done to increase the potential growth rate** | **13** |
| **Biography** | **14** |

# Economic Activity Transitions from Reopening to a New equilibrium

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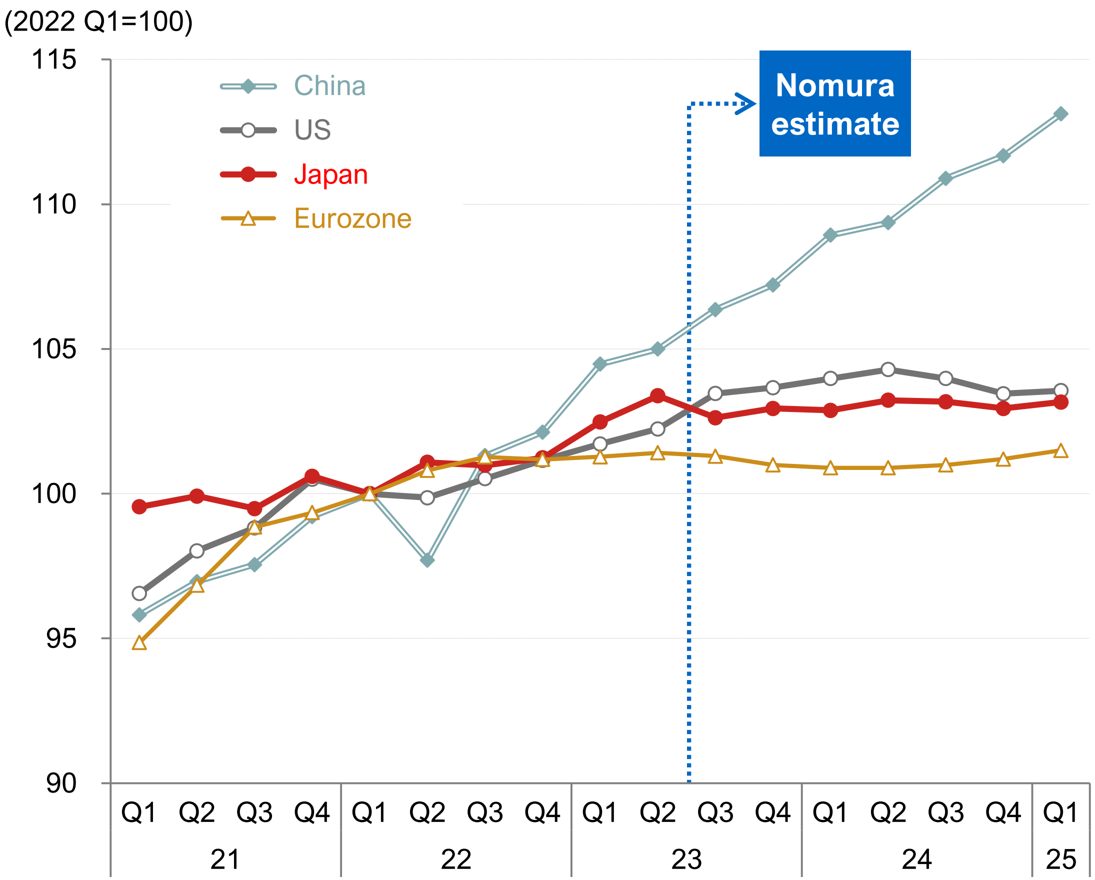
## Estimates for the real GDP of major countries/regions




In 2023, the major advanced economies of Japan, the US, and the EU transitioned from post-pandemic reopening to a steady state.

The central banks of the US and the Eurozone implemented significant rate increases until mid-year (July for the US and September for the Eurozone), but their economies reacted in contrasting ways. While the rate hikes did not dent economic growth (in terms of real GDP) in the US, the Eurozone appears to have entered a contraction phase in the latter half of the year.

In Japan, the Bank of Japan (BoJ) continued to maintain an accommodative monetary policy, keeping rates negative, among other actions. The economy showed steady recovery under these conditions, maintaining growth that bears comparison even to that of the US.

As we begin a new year, what we hope to see in 2024 is (1) further progress toward a virtuous cycle of wage and price increases, and (2) higher certainty that the Japanese economy is reawakening from its “lost 30 years.”

Note: Figures for 2022 Q1 (January – March) indexed to 100
Source: Nomura, based on official statistics

# The Differences Between Japan and the US on Inflation: (1) The Drivers

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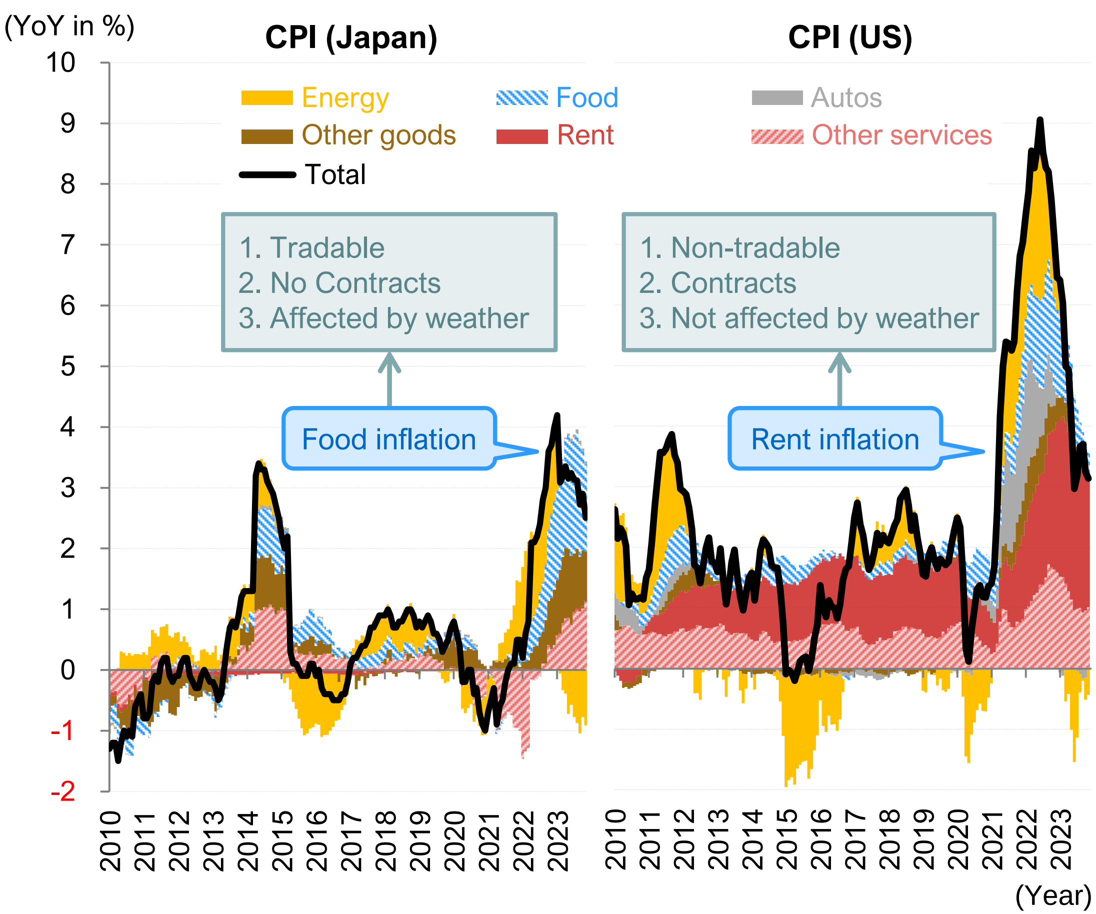
## What are the major contributors to higher Consumer Price Index (CPI) figures?




Based on the major drivers, inflation in Japan may be described as food-driven, while inflation in the US can be characterized as rent-driven.

As contributors to inflation, the major differences between food and rent are whether they are (1) directly tradable, (2) exchanged under contract, and (3) susceptible to weather conditions.

Of these three differences, the most relevant to this discussion is (1) tradability. Rent, the most significant contributor to inflation in the US, is non-tradable—an item that cannot be directly traded. Here, it is easy to determine that the cause of inflation is within the US economy and that is also where inflation is being experienced.

In Japan, on the other hand, the inflation driver is food. Food is actively traded and Japan relies particularly heavily on imports. When items that are largely imported are driving inflation, the inflation may be experienced in Japan, but the causes are not necessarily domestic.

Sources: Japanese Ministry of Internal Affairs and Communications, US Bureau of Labor Statistics, Nomura

# The Differences Between Japan and the US on Inflation: (2) Persistency

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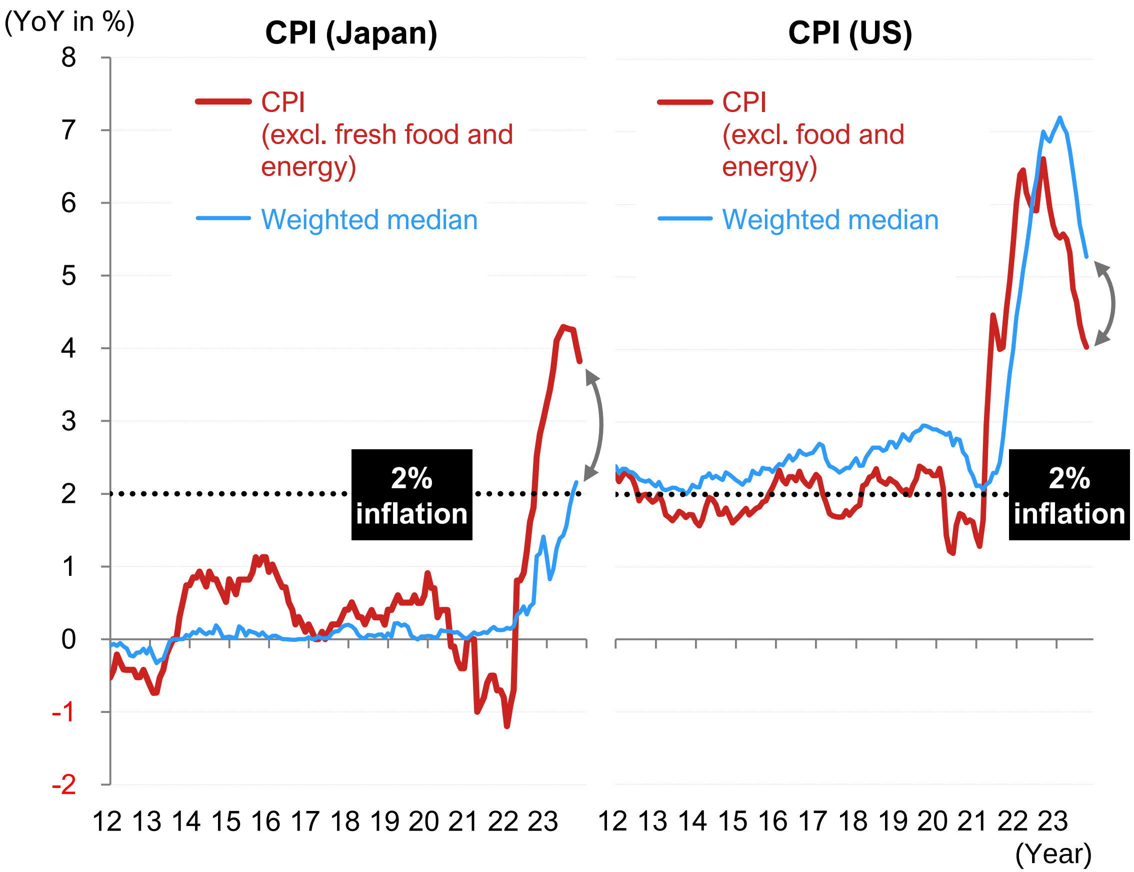
## Rate of change in the CPI: speed and persistence




Note: Weighted median is obtained by excluding items that fall into the top and bottom 47.5% (49.5% for the US) of the CPI basket in their price change rate distribution, and calculating the rate of change in the weighted average price index of the remaining items

Sources: Ministry of Internal Affairs and Communications, Bank of Japan, US Department of Labor, Federal Reserve Bank of Cleveland, Nomura

When we examine inflation, we must be sure to confirm the speed of change and its persistence. To assess the speed of inflation, we look to core-core CPI (which excludes fresh food and energy) for Japan and core CPI (which excludes food and energy) for the US. The figures are declining for both countries, with Japan following the US with a slight lag.

On the other hand, if we look at the weighted median (please see the explanatory note for the graphs at left) as an indicator of the persistence of inflation, the graphs show a clear downtrend for the US, while the line is still rising for Japan.

This difference between the US and Japan in the persistency of inflation will be significant as we anticipate the monetary policies of each in 2024. Specifically, with inflation slowing in the US, it is possible to see rate cuts on the horizon. In Japan, on the other hand, with inflation on course to grow more persistent, the end of negative rates and Yield Curve Control (YCC) could be within sight.

In the US, the Federal Reserve Board (FRB) will begin to cut interest rates in June 2024 while the BoJ will end negative rates and YCC in April 2024, in our view.

# Japan's Inflation Is Expected to Become More Sticky, but Remain Under 2%

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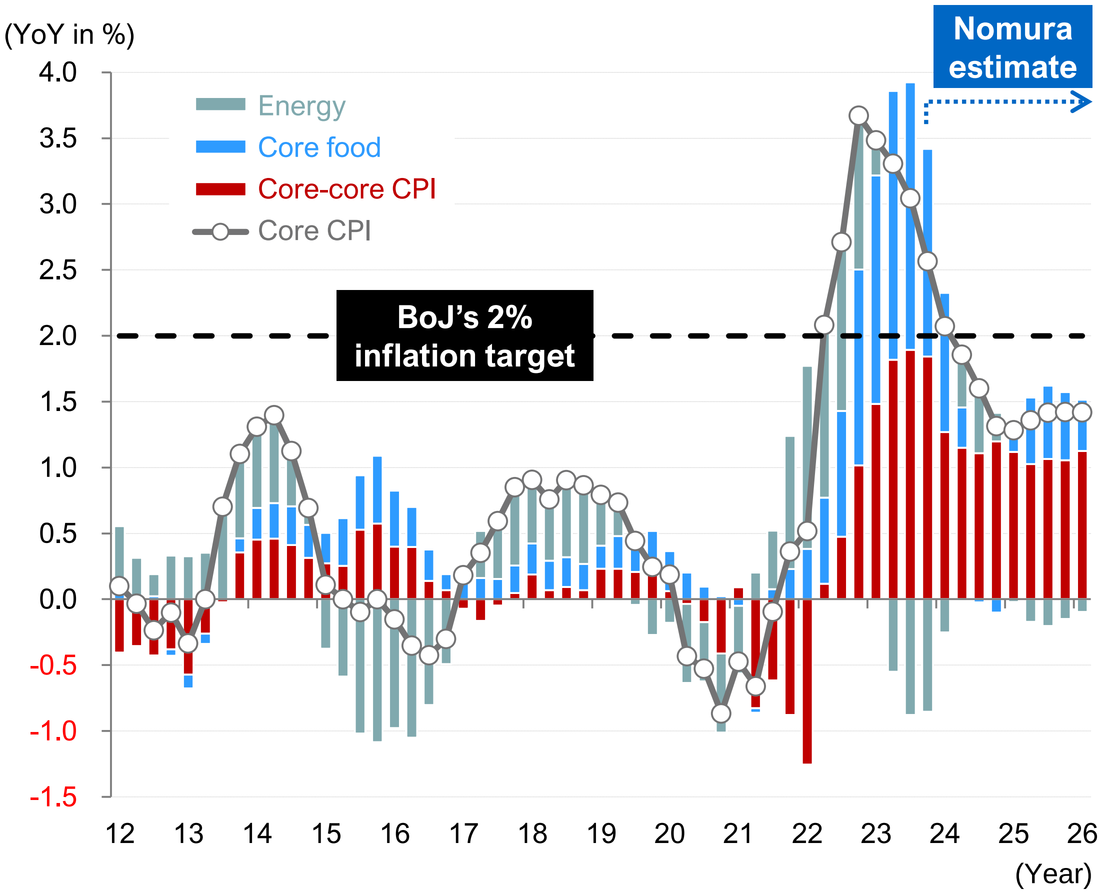
## Actual and projected core CPI (excluding fresh food)




Nomura expects the yen to strengthen against the dollar towards the end of 2025, and that the price of oil will gradually fall as well. These developments will have a suppressing effect on CPI inflation.

Additionally, based on media reports on various price increases, price hikes for foods can be expected to gradually slow down. Judging from this trend, food prices will stop pushing inflation higher by about the middle of this year.

Nomura also expects wage hikes of 3.9% (including periodic wage increases) following spring labor negotiations in both 2024 and 2025, a growth rate higher than the 3.6% increase agreed in 2023. In such an environment, we anticipate YoY inflation to stabilize in the high 1% range from around mid-2024, measured by core-core CPI, which excludes food (less alcoholic beverages) and energy, and is a better indicator of underlying changes in prices.

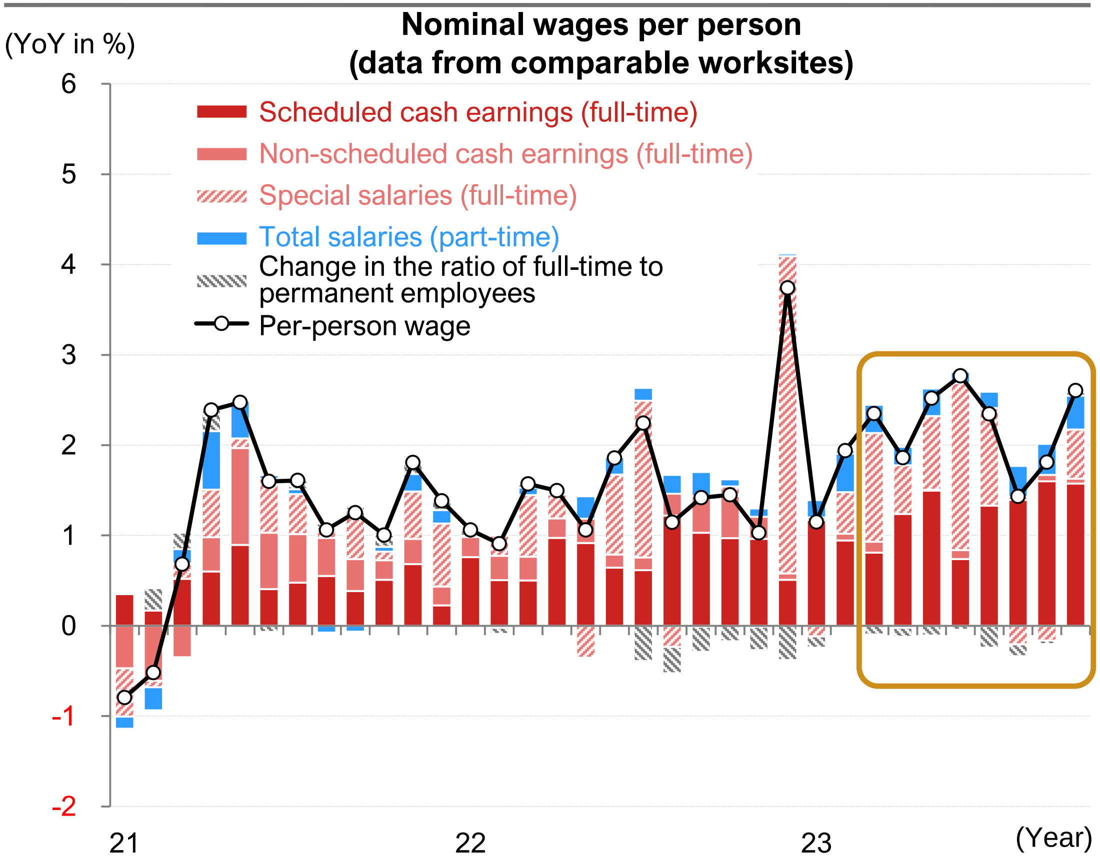
Even as core CPI inflation declines, it is expected to gradually become stickier.

Note: Core CPI excludes fresh food. Core-core CPI excludes energy and core food items (fresh food and other food less alcoholic beverages)

Sources: Actual figures from the Ministry of Internal Affairs and Communications, estimates by Nomura

# The Quickening Pace of Wage Increases

## Nominal wages are growing at higher rates




Wages are arguably the aspect of the Japanese economy that saw the greatest change in 2023.

The wage increase (including seniority-based wage hikes) determined through spring labor negotiations was 3.58%, the largest increase in some 30 years. A wage increase excluding seniority-based wage hikes also rose to 2.12%, so that scheduled cash earnings (mostly comprising base pay) made up a larger part of the increase in per-person nominal salary in 2023.

Wage growth in 2023 failed to keep pace with the rise in CPI, however. As a result, per-person real wages, an indicator of purchasing power, declined significantly, by about 2% from the previous year.

Even so, the fact that prices and wages (nominal wages) have begun to rise in tandem is one of the major changes seen in the Japanese economy in 2023.

Notes: 1. "Comparable worksites" refer to worksites that were covered by the survey for both the month indicated and the same month of the previous year. Worksites that do not meet this description are excluded from the data.
2. "Scheduled cash earnings" comprises fixed components of pay such as base pay and family allowance, and excludes non-scheduled cash earnings.
3. "Non-scheduled cash earnings" includes non-fixed components of pay such as such as overtime and holiday pay.
4. "Special salary" comprises such items as summer/winter bonus and across-the-board pay increase added retroactively over the applicable period.
5. "Ratio of full-time to permanent employees" refers to the percentage of full-time employees to the total of full-time and part-time employees.

Source: Monthly Labour Survey of the Ministry of Health, Labour and Welfare, Nomura

# Yield Curve Control (Long-term Interest Rate Manipulation) Is Increasingly Ineffectual

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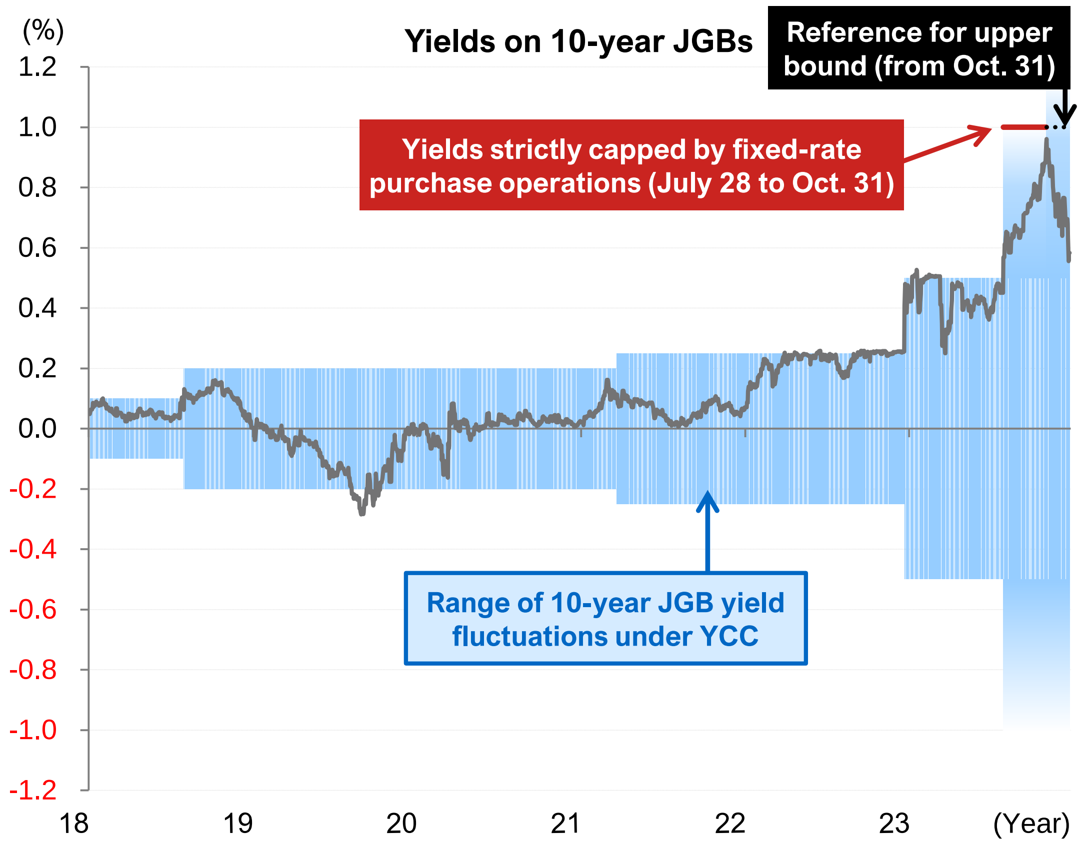
## YCC is increasingly ineffectual




In April 2023, Kazuo Ueda succeeded Haruhiko Kuroda as the Governor of the BoJ. The market watched with keen interest whether the installation of a new governor would usher in policy changes, but with a virtuous cycle between wages and prices not yet sufficiently established, the BoJ patiently continued its accommodative monetary policy for the remainder of the year. At the same time, this forced the BoJ under Governor Ueda to continue balancing both the positive effects and negative side effects of the accommodative policy.

Faced with these conditions, what the BoJ chose to change in 2023 was YCC. First, it announced a decision on July 28 to introduce greater flexibility, re-characterizing its +/-0.5% fluctuation limit for 10-year JGB yields as a “reference range” and increasing the hard cap (which it enforces through fixed-rate purchase operations) from 0.5% to 1.0%.

The BoJ went further on Oct. 31, when the 1.0% limit also became a “reference,” fueling the widespread view in markets that YCC is on the cusp of being dismantled.

Note: Of the permitted fluctuation range for 10-year JGBs, which is indicated in light blue, the shaded area from July 28, 2023 does not reflect a particular yield level.

Source: Bloomberg, Nomura

# Widening Difference in Policy Interest Rates

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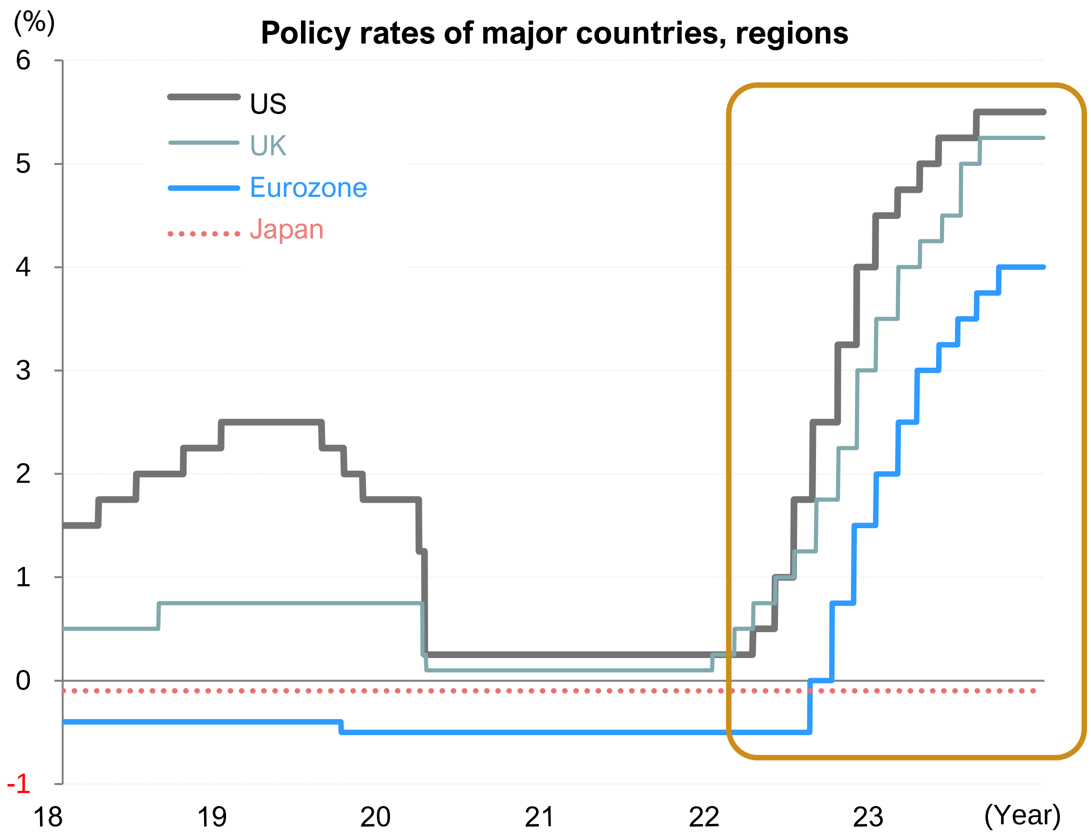
## Japan alone maintains negative interest rates




Unlike YCC, which has become increasingly ineffectual, the BoJ maintained its negative interest rate policy throughout 2023. (The negative interest rate levied on the "policy rate balance," a balance that makes up 4-5% of the BoJ's current accounts, is now at -0.1%.)

In contrast, major Western central banks such as the FRB of the US and European Central Bank (ECB) continuously raised their interest rates until mid-2023 (until July in the US and UK, and until September in the Eurozone). The result has been a widening of interest rate spreads between these economies and Japan.

Given this situation, the market is watching with keen interest the timing of the BoJ's possible exit from its negative interest rate policy. However, there appears to be no consensus even within the BoJ on what an exit might mean in terms of its impact on the economy.

The BoJ's stated basis for this decision—achievement of a virtuous cycle between wages and prices—is the most fundamental of criteria. And yet, uncertainties remain over the policy impacts that such a move would bring.

Notes: 1. For the US: the policy rate is the upper limit of the target range for the Federal funds rate
2. For Japan until Feb. 15, 2016: the unsecured overnight call rate; from Feb. 16, 2016: negative interest rate applied to part of the outstanding balance of each financial institution's current account at the BoJ (from April 2013 to January 2016, however, no policy rate existed, with monetary policy based solely on the quantitative indicator of the outstanding balance at BoJ current accounts)
3. For the Eurozone: the deposit facility rate
4. For the UK: the Bank Rate

Source: Bloomberg, Nomura

# Pivot Expected for US Monetary Policy

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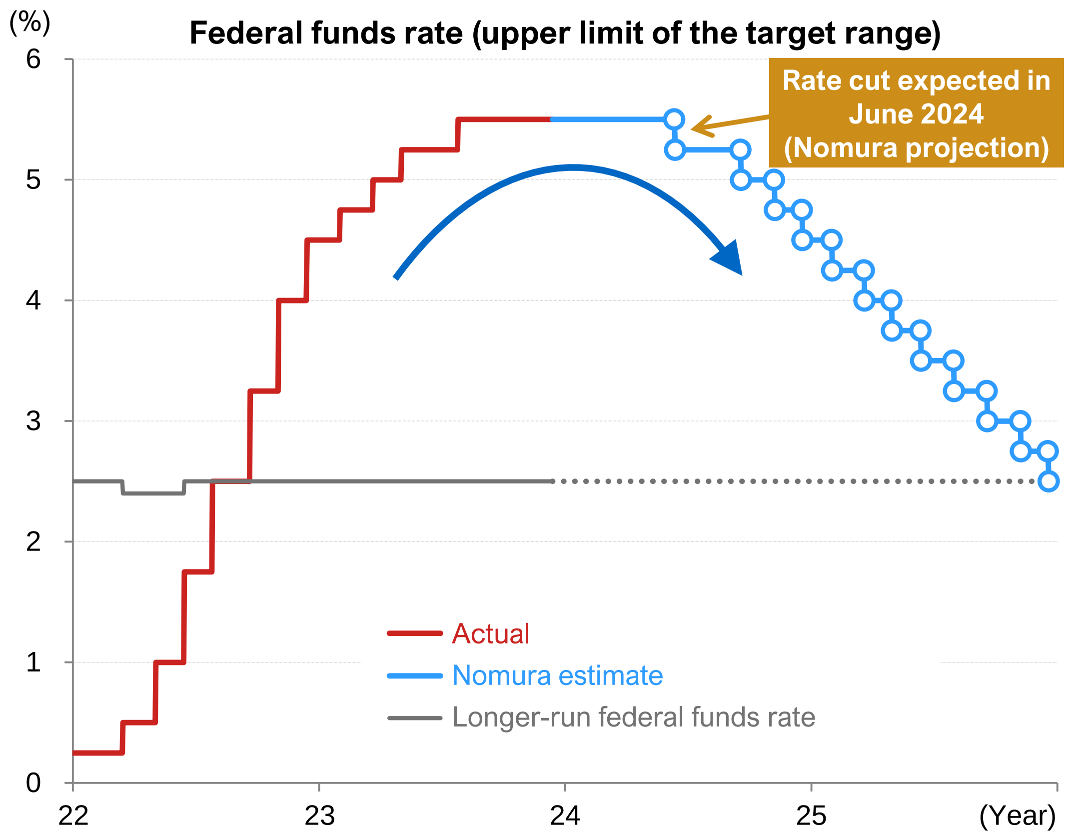
## The US is expected to begin cutting rates in June 2024




US monetary policy has the potential to impact prices in Japan through exchange rates.

Nomura expects the FRB to begin lowering its policy rate, the federal funds rate, in June 2024. By the end of 2025, the federal funds rate could be as low as 2.5%, the FRB's median longer-run projection as of December 2023. This will likely result in a weaker dollar (and a strengthening of the yen against the dollar) from 2024 onwards.

In general, a depreciation of the dollar against the yen exerts downward pressure on inflation in Japan. This is one reason some expect it will be more difficult for the BoJ to exit its monetary easing policy (i.e. end negative interest rates) after the FRB pivot begins and sends the dollar falling against the yen.

However, if there is progress toward the BoJ's target of a virtuous wage-price cycle, the causes of inflation in Japan can be attributed to factors in the domestic economy. If that proves to be the case, it should be possible for the BoJ to cease its negative interest rate policy even amid a dovish pivot by the FRB.

Note: The longer-run federal funds rate plotted in the graph is the median of longer-run federal funds rate projections of Federal Open Market Committee (FOMC) participants.

Sources: Federal Reserve Board for actual figures, estimates by Nomura

# The "Virtuous Cycle Between Wages and Prices" Desired by the BoJ

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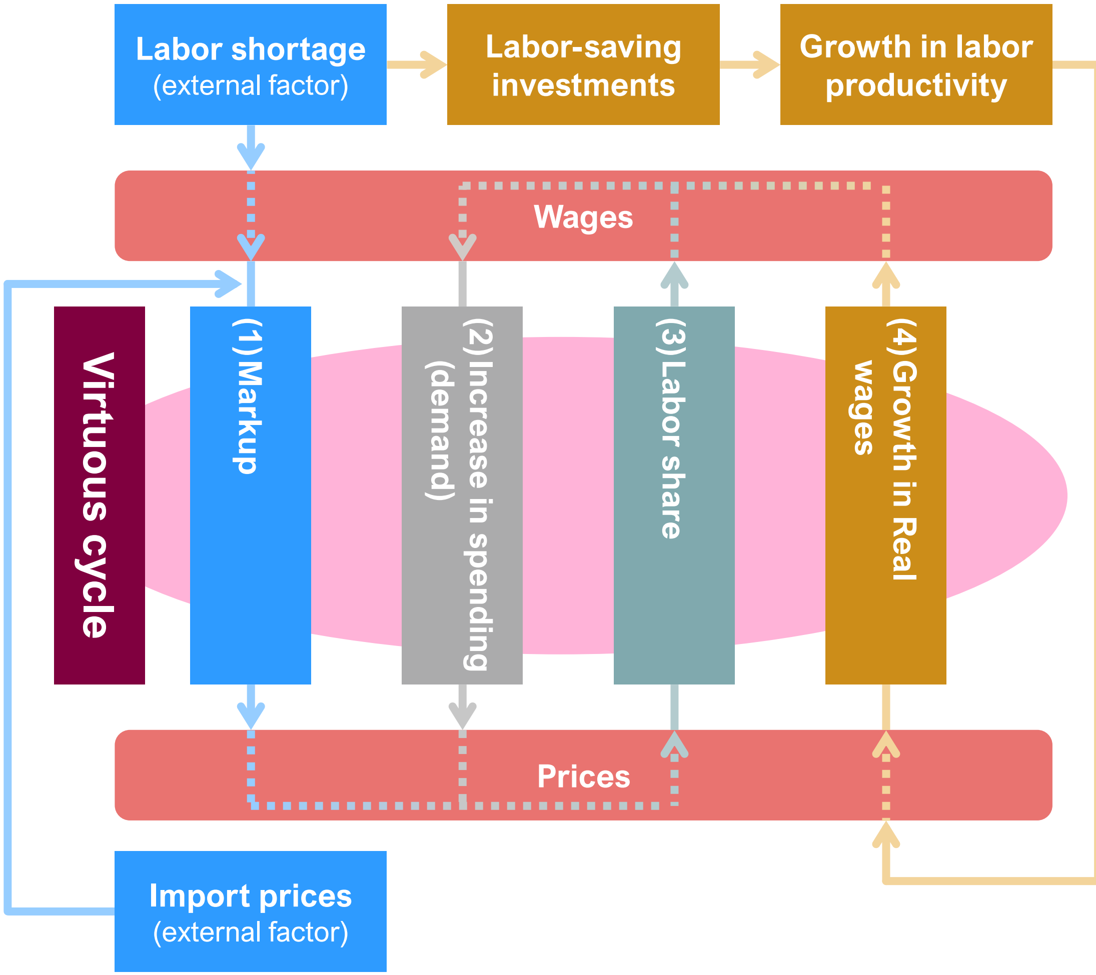
## Four channels of the "virtuous cycle between wages and prices"




Source: Nomura

Amid increases in both wages and prices, the question in 2024 will be how much progress is made toward a "virtuous cycle between wages and prices."

There are four ways in which increases in wages and prices feed into each other:

(1) Mark-ups (the extent to which companies increase the price of their products in response to additional costs such as higher labor)

(2) Spending (the extent to which companies increase the price of goods and services in response to higher spending by households receiving higher wages)

(3) Labor share (the extent to which companies charging higher prices raise workers' wages)

(4) Real wages (the extent of wage increases, given a certain increase in prices)

Of the above, (1) and (2) are channels by which wages affect prices, while (3) and (4) are channels by which prices affect wages.

# The Green Shoots of Additive Profits are Beginning to Appear

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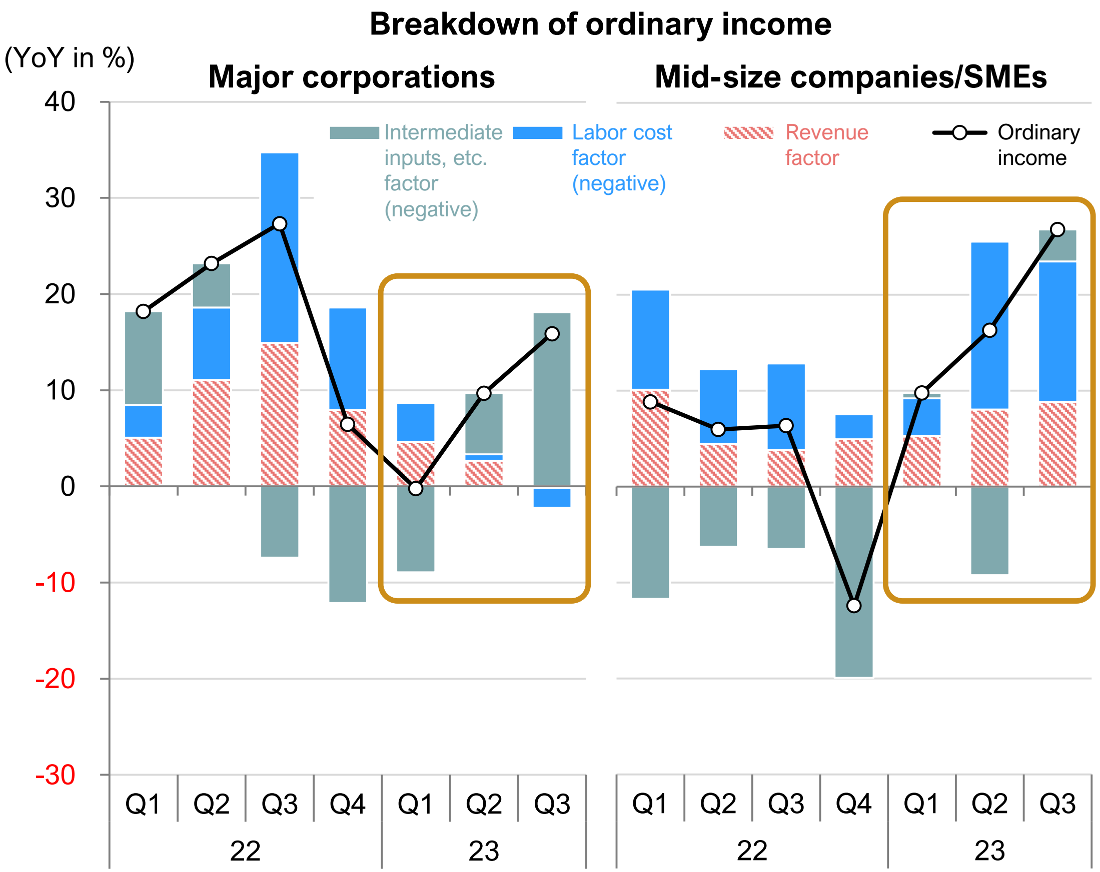
## The revenue factor is contributing to higher profits at mid-size companies and SMEs




To what extent did the Japanese economy make headway in 2023 toward a virtuous cycle of wages and prices? While we have yet to see sufficient progress, two channels—(1) Mark-ups and (3) Labor share—are growing more robust.

Specific evidence for the latter is the spring wage negotiations of 2023, which saw agreement on wage increases that were the largest in some 30 years.

In the area of mark-ups, it was encouraging to see the positive contribution of revenue factors in the growth in profit achieved by mid-size companies and SMEs, who account for some 40% of the profits generated by Japanese corporations.

Some of the increase in profits was still driven by cost cuts, which are subtractive in nature, but 2023 also saw the beginnings of additive, revenue-driven profit growth, indicating that the mark-up channel, while still underdeveloped, was starting to emerge.

Notes: 1. Major corporations are companies with capital of JPY1bn or more; mid-size companies/SMEs are companies with capital of JPY10m or more, but less than JPY1bn
2. The breakdowns in the above figure are calculated as follows:
% change in ordinary income = (1) % change in revenue – (2) (% change in labor cost - % change in revenue) x labor cost in the same period of the previous year ÷ordinary income in the same period of the previous year – (3) (% change in intermediate inputs, etc. - % change in revenue) x intermediate inputs, etc. in the same period of the previous year ÷ordinary income in the same period of the previous year
Of the above, (1) is described as a revenue factor, (2) is described as a labor cost factor (negative), and (3) an intermediate costs, etc. factor (negative)

Source: Financial Statements Statistics of Corporations by Industry, Ministry of Finance, Japan; Nomura

# Five Alarm Bells Are Ringing in Japan

## Will Japan awaken from its 30-year slumber

| Two sources of structural change | Five alarms |
|---|---|
| 1. Demographic change (declining birthrate and aging population) (population decline) | (1) **Rapid decline in the population aged 15 and above** from 2021 onwards |
| | (2) **Decline in the additional labor** provided by women and older workers |
| | (3) Increasing urgency for **firms headed by aging leaders to find successors** |
| 2. Market pressures | (4) **Requests from the Tokyo Stock Exchange** for corporations with a P/B ratio of less than 1 **to improve capital efficiency** |
| | (5) Greater scrutiny placed on companies, due to the inflow of new investors brought about by the **New NISA program** and the **unwinding of cross-shareholdings** |

Source: Nomura

Amid insufficient but sure progress toward a virtuous cycle between wages and prices, we can discern a glimmer of hope that Japan will leave its "lost 30 years" behind.

The keys to such a change are two sources of structural change and five alarm bells.

The two sources of structural change are 1. demographic change (a declining birthrate and aging population, together with population decline) and 2. market pressures.

These structural changes have set off five alarms warning of (1) a rapid decline in the population aged 15 and above from 2021 onwards, (2) decline in the additional labor provided by women and older workers, (3) increasing urgency for firms headed by aging leaders to find successors, (4) requests from the Tokyo Stock Exchange for corporations with a P/B ratio of less than 1 to improve capital efficiency, and (5) greater scrutiny placed on companies, due to the inflow of new investors brought about by the new NISA program and the unwinding of cross-shareholdings.

Will the simultaneous ringing of five alarms jolt the Japanese economy out of its 30-year torpor? We look forward to seeing what the Japanese economy will achieve in 2024 and beyond.

# Labor Mobility

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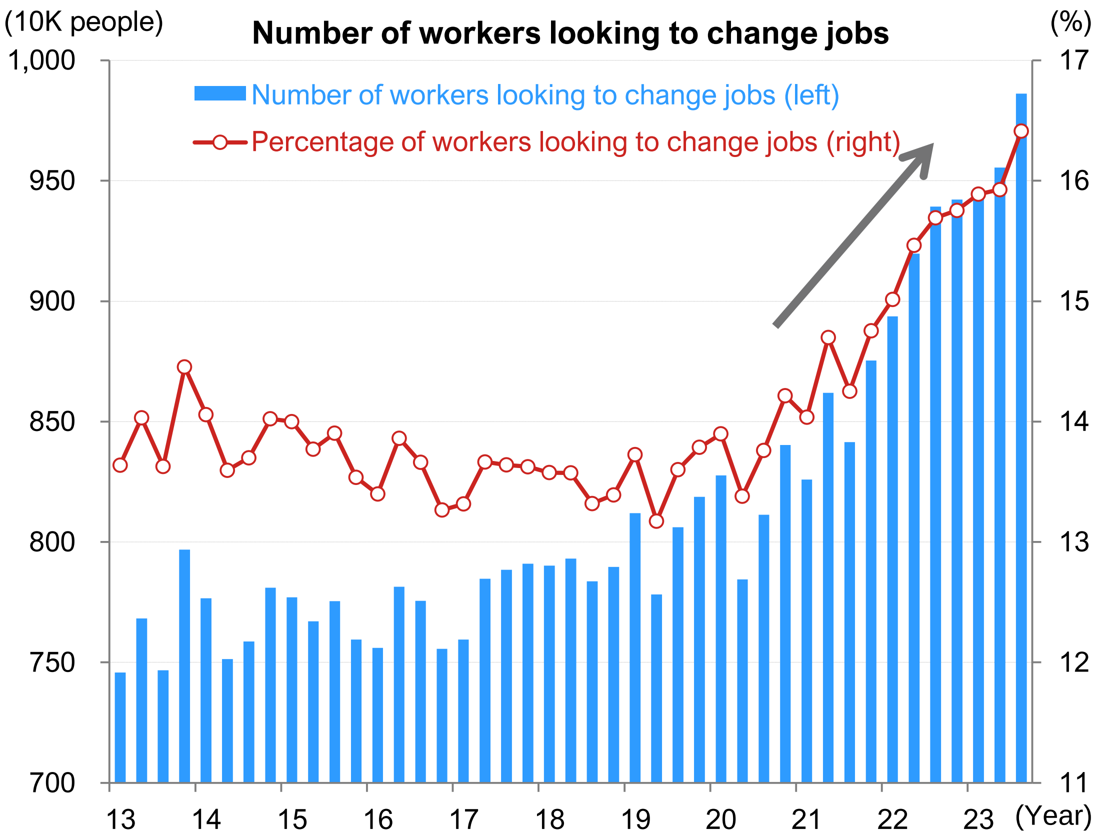
## Growing numbers of employed workers are seeking new jobs




Wage increases alone, regardless of how generous they are, will not resolve the shortage of labor at a macroeconomic level. The current environment also calls for an optimal reallocation of the existing workforce.

One relevant change taking place in the Japanese economy is the growth in labor market mobility. A survey by the Ministry of Internal Affairs and Communications puts the number of workers looking to change jobs at nearly 10 million, a number equal to 16-17% of total employment.

Through the reallocation of its workers, the Japanese economy as a whole could improve its labor productivity. If this can be achieved, and if individual companies continue labor-saving investments, it could open the way to sustained growth in real wages.

Note: “Percentage of workers looking to change jobs” is the number of workers looking to change jobs divided by the total number of workers in non-agriculture/forestry sectors

Source: materials from the Ministry of Internal Affairs and Communications, Nomura

# What Can Be Done to Increase the Potential Growth Rate

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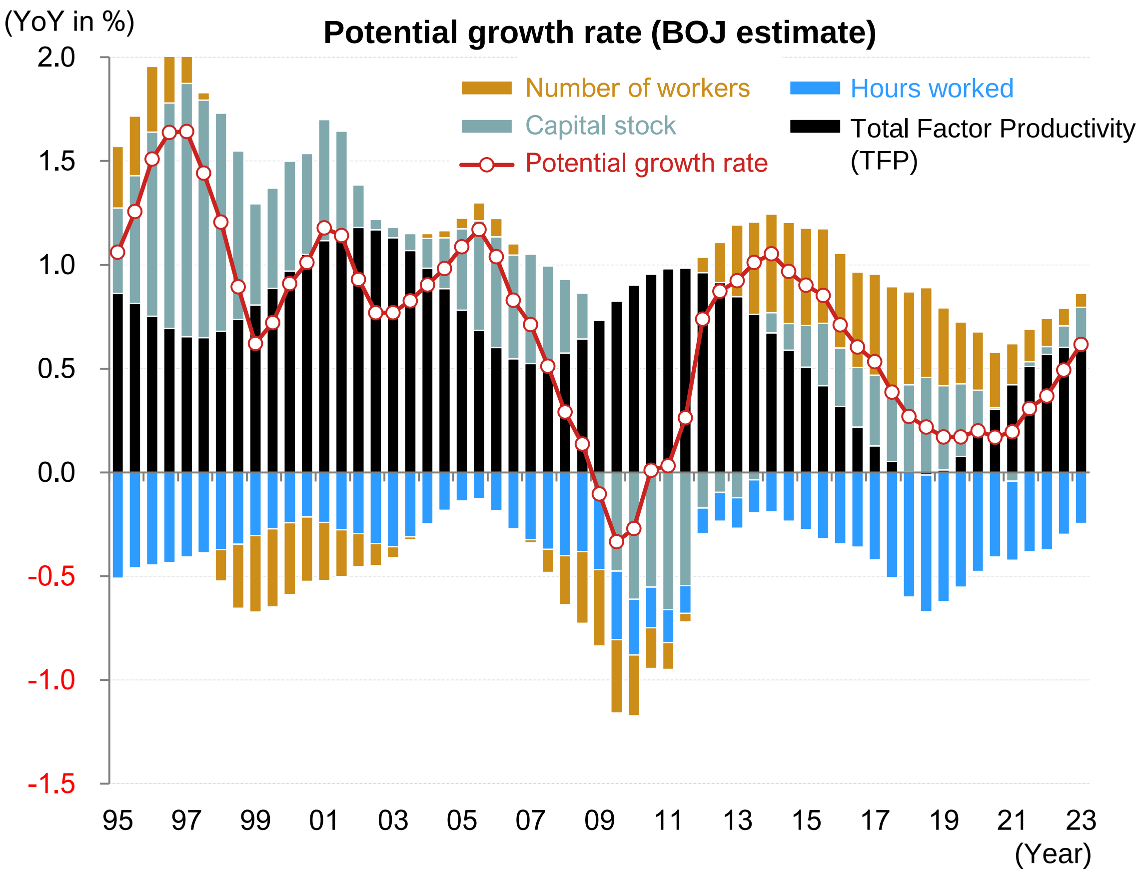
## Total Factor Productivity* is beginning to drive Japan's potential growth rate




According to an estimate by the BoJ, the potential growth rate of the Japanese economy has been anemic at around 0.5%. Since the early 2010s, labor participation by women and the elderly has increased, expanding the workforce and exerting upward pressure on the potential growth rate, but there is now limited scope for the workforce to continue to grow. This is where Japan's potential to increase Total Factor Productivity (TFP) will come under scrutiny.

At the individual level, efforts to increase productivity include (1) recurrent education (structured learning for people already in the workforce) and (2) reskilling (the learning of new knowledge and skills to adapt to changes such as technological innovations).

And at the macro level, the economy needs to be restructured more swiftly, which will require legal and systematic changes to facilitate the reallocation of workers to prospective growth industries.

* Total Factor Productivity is one of the factors leading to economic growth (higher GDP), and refers to qualitative growth factors that account for growth that is not explained by quantitative inputs such as capital and labor. Some examples of TFP are technological innovation and more efficient production methods. Because TFP cannot be directly measured, it is interpreted to be all economic growth not accounted for by the contributions of inputs other than TFP factors.

Source: materials from the Bank of Japan, Nomura

# Author biography

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**Kyohei Morita**

Chief Economist

As Nomura's Chief Economist, Kyohei Morita analyzes macroeconomic trends across countries and regions, and financial markets across asset classes, to predict what lies ahead for Japan's economy. He is particularly well-versed in monetary policy, having written on the subject for his doctoral thesis; he received his PhD in Economics from Kyushu University in 2018.

Since joining Nomura Research Institute in 1994, he has been engaged in macroeconomic analysis and forecasting. He was at the UK head office of Nomura Research Institute Europe from 2001 to 2004, providing in-depth analysis and forecasts of the Japanese economy for Japanese equities investors in the UK, continental Europe, and the Middle East. During this period, he had opportunities to visit some 500 investors each year. Over the next 14 years, he served as Chief Economist at Barclays Securities (2008-2017) and Credit Agricole (2017-2022). He became Chief Economist at Nomura Securities in 2022.

After graduating from Kyushu University School of Economics in 1994, Kyohei continued his studies at the Graduate School of Brown University from 1998-2000, earning a Master's Degree in Economics. As non-traditional monetary policy came to be adopted around the world, he began work on a doctoral thesis to deepen his understanding of the theoretical and historical underpinnings, culminating in "A Consideration of Monetary Policies Under Low Natural Interest Rates." He received his doctoral degree in economics from Kyushu University in 2018.

As an economist, Kyohei focuses on (1) data analysis that is detailed but easy to understand, (2) generating global, rather than local, economic scenarios, and (3) central bank watching based on meticulous data analysis. Institutional investors have appreciated his insights: thanks to their votes, Kyohei placed fourth among economists ranked by Nikkei Veritas in 2022.

Kyohei has also contributed to books on economic issues: Asset Formation in an Age of Population Decline (Toyo Keizai, 2005) and Modern Financial Theory, new ed. (Yuhikaku, 2016). He is a frequent guest on the TV Tokyo program, News Morning Satellite, and contributes regularly to Deep Dive into Market Topics by Top Economic Analysts on Diamond Online

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Publication date: January 4, 2024

**This material was created as reference material for Nomura Securities' Japan in the World event to be held in January 2024**