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Japanese companies' growing willingness to pass through cost increases bodes promisingly for inflation

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Executive Summary

Since the mid-2010s, price cutting by Japanese companies has drastically decreased in prevalence. As a result, it has created an environment much more conducive to CPI inflation driven directly by corporate price-hiking, including price increases to pass through cost inflation.

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Is actual inflation already near 2% in Japan?

Following the omicron variant's emergence, we have entered 2022 with no clarity on how much longer the pandemic will last. Visibility with respect to the inflation outlook and timeline for rectification of global supply chain disruptions likewise remains murky.

Against such a backdrop, producer price indexes are soaring globally, including in Japan, driven mainly by commodity/materials price inflation. In December 2021, Japan's YoY PPI hit a 41-year high of +8.5% (per preliminary data).

Japan's CPI, by contrast, has barely budged so far, reflecting that Japanese companies have been absorbing surging input cost inflation through various means. The headline CPI's November reading was a mere +0.6% YoY despite a 1.44ppt[1)] boost from food and energy inflation.

Food and energy's positive contribution to YoY inflation was offset by mobile phone plan pricing cuts made at the behest of former prime minister Yoshihide Suga. Such policy factors detracted from the YoY CPI's November reading by a net 1.14ppt[2)], in the absence of which the November CPI would have been +1.7% or perhaps even +1.8%. This adjusted CPI is more reflective of actual inflation in Japan. In other words, inflation is arguably already closing in on the BOJ's +2% target, a key milestone for gauging the monetary policy outlook.

NOTE

1) According to the MOF's Statistics Bureau, food and energy respectively contributed +0.37ppt and +1.07ppt to the November headline CPI's YoY reading of +0.6%.

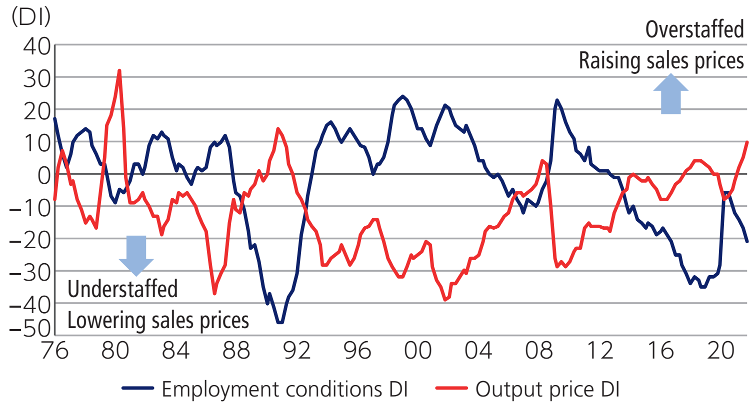
2) According to the MOF's Statistics Bureau and media reports, lodging away from home contributed +0.34ppt to the November headline CPI's YoY reading. Its sizable positive contribution was seen as a base effect of a year-earlier government program to promote travel by offering government-subsidized discounts on hotel accommodations. Meanwhile, mobile phone service detracted 1.48ppt from the November headline CPI's YoY reading as a result of mobile phone plan pricing cuts in response to pressure from former PM Suga's government.

Japanese companies' changing attitude toward passing through cost inflation is evident in *Tankan* data

If Japan's inflation rate really is approaching +2%, Japanese companies' pricing, including their long-standing hesitancy to pass through cost increases to customers, also must be changing. In fact, the BOJ's initial account of its Policy Board's discussions at its December Monetary Policy Meeting[3] contained multiple mentions of changes (including prospective changes) in companies' pricing behavior.

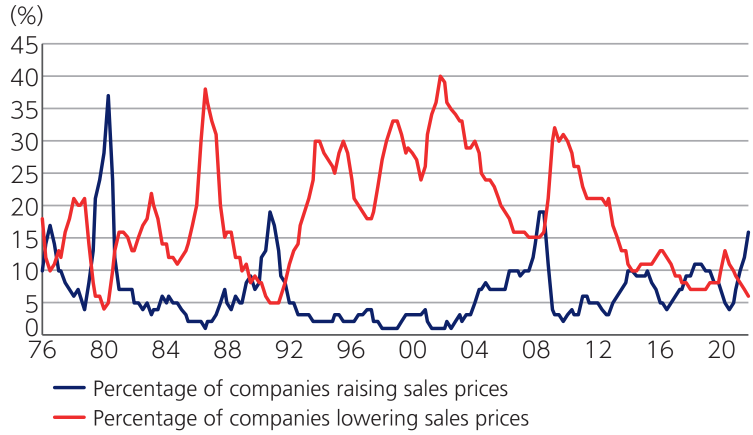
3) BOJ's Summary of Opinions at the Monetary Policy Meeting on December 16-17, 2021, released December 27 (https://www.boj.or.jp/en/mopo/mpmsche_minu/opinion_2021/opi211217.pdf)

Figure 1: *Tankan* output price and employment conditions DIs



Source: NRI, based on BOJ data

Figure 2: Output price DI's constituent percentages



Source: NRI, based on BOJ data

Additionally, in the BOJ *Tankan*, a quarterly survey of over 9,300 companies throughout Japan, the output price DI (diffusion index) for all sizes of companies across all industries, calculated as the percentage of companies raising sales prices minus the percentage that are lowering sales prices, came in at +10 in the December 2021 survey (Figure 1). Only twice previously since the early 1980s has the output price DI registered a double-digit positive reading. The other two occasions were December 1990 and March 1991[4], at the tail end of Japan's historic asset bubble.

4) The output price DI's December 1990 and March 1991 readings were +14 and +12, respectively.

While the output price DI's latest positive double-digit reading is highly significant in and of itself, the DI's current internals are even more noteworthy (Figure 2). While the DI may be the best gauge of what is happening with sales prices within Japan from a macro perspective, the DI's two inputs (the percentages of companies respectively reporting sales price cuts vs. increases) provide a more concrete picture of how companies are actually pricing their products and services.

For example, the output price DI's December 2021 reading of +10 was the result of 16% of respondents reporting price increases and 6% reporting price cuts. Back in 2008, by comparison, when WTI crude oil shot up to an all-time high of $147.27 in July, 19% of *Tankan* respondents reported they were raising prices in the June and September surveys, the timeframe when energy price inflation was most onerous. Although the percentage of companies raising prices was three points higher in June-September 2008 than in December 2021, the output price DI was 6-7 points lower (+4 in June and +3 in September vs. +10 in December 2021), as shown in Figure 1. In June-September 2008, 15-16% of respondents reported they were lowering sales prices, more than double the 6% that reported doing so in December 2021. Companies in 2008 absorbed a lot of cost-inflationary pressure stemming from crude oil prices.

In sum, many Japanese companies continually lowered sales prices from the 1990s into the early 2010s, when the deflation narrative was in full swing. Their price cutting was likely one factor behind the persistence of the Japanese economy's deflationary undercurrent.

More aggressive pass-through of cost inflation would hasten monetary policy normalization

However, the deflationary pressure emanating from the corporate sector abruptly subsided after Abenomics was launched in late 2012. Over the past few years, the percentage of companies lowering sales prices has been roughly on a par with its level during the latter half of the 1980s, when the Japanese economy was booming (Figure 2). Although Japan's actual inflation rate failed to reach the BOJ's +2% target during the Abenomics era because of companies' reluctance to raise prices (Figure 2), even Japan is now on the verge of realizing the stable inflation to which today's central banks aspire.

If the nascent trend toward companies passing through cost inflation to customers keeps gaining momentum, sustained inflation in the vicinity of +2% would become increasingly attainable even in Japan. If, for example, supply chain disarray persists as a result of further prolongation of the pandemic or if energy prices continue to rise in the wake of the decarbonization trend, companies would have to pass the resultant cost increases through to their customers.

Additionally, Japan is facing a structural labor shortage due to population shrinkage. According to the BOJ *Tankan's* employment conditions DI (percentage of overstaffed companies minus percentage of understaffed companies) for companies of all sizes across all industries, understaffed companies have long outnumbered overstaffed companies and continue to do so even during the pandemic (Figure 1). A persistently tight labor market should give rise to sustained wage inflation that companies will presumably seek to pass through to customers whenever they can, such as when they roll out new products or services.

If inflation takes root in Japan, the BOJ would likely be forced to rapidly normalize monetary policy.

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