Registration No.: Director of Kanto Local Finance Bureau
(Financial Instruments Firms) No.324
Commodity Trading Advisor License #(1) No.24, the Minister of Agriculture, Forestry and Fishery & the Minister of Economy, Trade and Industry
Member of Japan Investment Advisers Association
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How Sustainable are Rising Prices in Japan Today versus 2014?

13 May 2022

- In Japan, inflation as measured by the core CPI is expected to exceed +2% YoY in April 2022 and is expected to remain above 2% throughout 2022.
- In 2014, when the CPI last exceeded 2%, price increases were not sustainable due to weak consumption. This time, a combination of timely response from the government, accumulated savings post-pandemic and normalizing of economic activity are expected to support consumption.
- We believe that there have been transformations in the pricing behavior of companies, such as dynamic pricing in response to demand and raising prices of higher added value products.
- This round of price hikes, which has been triggered by a surge in the price of imported raw materials could be the first opportunity since 2014 for a change in Japan's price outlook, boosted by the efforts to retain employees on the labour shortage and the Kishida Government's distribution policy.

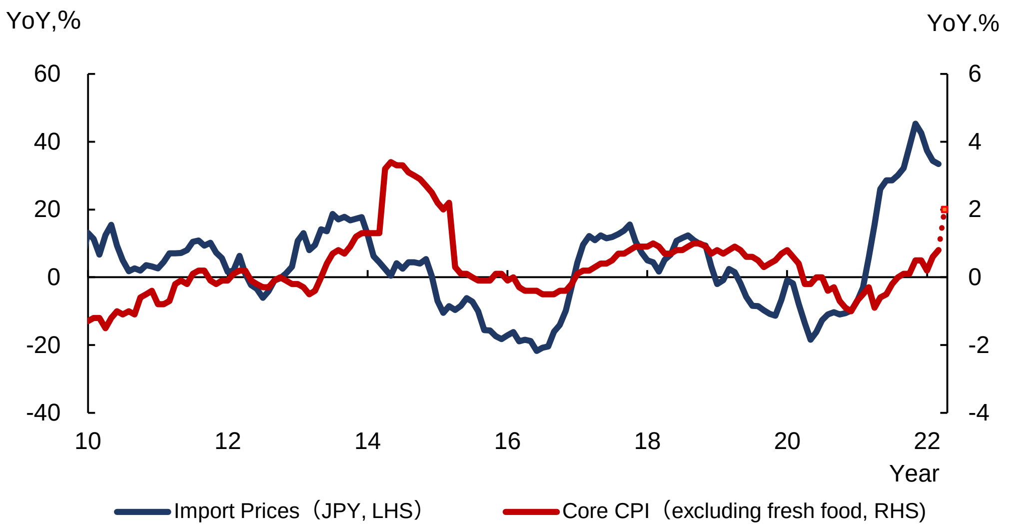
Yuko Iizuka, Economist

“Inflation rate to reach 2% in Japan”

While price increases are accelerating globally and many countries are turning to monetary tightening, the rate of price increases in Japan has been relatively low and below the BOJ’s price target of +2%. Demand for raw materials and component shortages following post Covid-19 pandemic economic normalization and the Ukraine crisis have pushed up prices of food, electricity, gas and petrol worldwide. In Japan, these items have also risen significantly: in March 2022, 63% of the 582 surveyed items in the Consumer Price Index were positive year-on-year, and there are ongoing reports of future planned price increases by manufacturers. Meanwhile, in Japan, mobile phone tariffs were significantly reduced in April 2021, which has helped to keep the rate of price increases under control, pushing down the CPI by around 1.4 percentage points in March 2022. However, the YoY change in the CPI (CPI excluding fresh food, hereafter core CPI) is expected to rise substantially to reach +2% in April 2022 (Figure 1), as the negative base effect from the impact of the reduction in mobile phone tariffs will no longer be reflected in the CPI on YoY basis. If the YoY change in core CPI exceeds +2%, it will be the first time since 2014 that this has happened.

In the next section, we will compare and contrast with 2014 to examine the sustainability of this round of price increases.

Figure 1: Rate of Increase in Import prices and Core CPI



Source: NEEDS-FinancialQUEST
Period: Monthly data from Jan. 2010 to Mar. 2022 (Core CPI data to Apr. 2022)
Note: Core CPI data of Apr. 2022 is based on AMOne projections

"Review of FY2014"

In FY2014, the core CPI was +2.8% YoY, of which 2.0% was attributable to the consumption tax rate increase from 5% to 8% (based on a calculation by Ministry of Internal Affairs and Communications). Given that the increase in the consumption tax rate in April coincided with regular price revisions at the start of the new fiscal year, it is believed that tax-inclusive prices were generally increased based on corporate efforts to pass on rising costs due to the weaker yen and other factors at the conjuncture. There were signs of a change in the pricing behaviour of companies, encouraged by the government's call for an end to deflation and pressure on companies to raise wages. According to the BOJ's Tankan survey, companies' 3 year pricing forecasts were +1.7%, with a medium-term outlook of close to 2% (Figure 2).

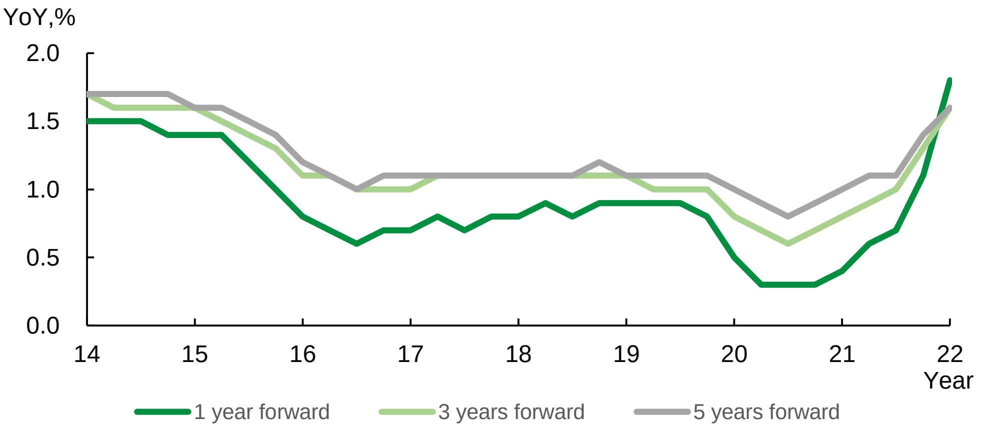
However, price increases were not sustainable, as the sense of burden prevailed among consumers due to the slow delivery of benefits to low-income earners and households raising children, etc., which were put in place to counteract the tax hike. This coupled with a bout of bad weather in the summer after the tax hike cooled consumption.

Comparing 2014 and this time around, while the underlying trigger of rising prices is different – domestic tax increase as in 2014 as opposed to surging global raw material prices as at present – similarities exist, in that monetary easing is still being implemented towards the +2% price target and import prices are once again rising through the weakening of the yen. The BoJ's inflation outlook for companies looks also similar, with +1.5% in one year and +1.7% in three and five years according to the March 2014 survey, and +1.8% in one year and +1.6% in three and five years according to the March 2022 survey – all in the range of 1.5 and 2.0% (Figure 2).

"Can Japanese consumers absorb rising prices this time around?"

One important difference is government response. This time, the government has been providing subsidies to oil wholesalers in order to reduce the impact of the rise in petrol and other prices, and has also extended cash flow support for small and medium-sized enterprises and put forward additional benefit payments to those in need. For households, which represent 60% of Japanese GDP, we note two key differences between now and 2014: 1. Higher savings rates and 2. Greater visibility on the pricing outlook relative to 2014. As consumption has been undermined by consecutive waves of the COVID pandemic, accumulated savings remain largely unspent as surplus consumer spending capacity. Furthermore, in addition to this, the rising cost of raw materials is more transparent and understandable, meaning that various price hikes may be easier to anticipate and plan for consumers this time around. Another interesting point of divergence, is that whereas some demand was pre-empted before the consumption tax rate was raised in 2014, this time we are in a phase of normalization of economic activity following on from constrained consumer spending conditions amid the pandemic, thus we do not consider a significant fall in consumption as a major risk factor.

Figure 2: Companies' Price Outlook (BOJ's Tankan survey)



Source: BOJ
Period: Quarterly data from Mar. 2014 survey to Mar. 2022 survey
Note: Average of companies' overall price outlook

In the context of the pandemic and rising raw material prices, we are beginning to see evidence in the market that suggests a shift away from low-price competition to maintain sales volumes as companies begin to adopt dynamic pricing strategies. Dynamic pricing is a demand-based variable pricing system, and we believe that the pandemic may have prepared the Japanese consumer mindset for this type of pricing, as demand for social distancing demonstrated the added value and comfort of avoiding congestion. Variable prices according to the time of year have already been in place for airfares, for example, but the strategy is beginning to be adopted for theme parks and rail fares.

"Potential change in price perceptions"

Alongside variable pricing, some retailers are also pursuing a different strategy. Rather than simply raising prices, this premium price point strategy typically involves maintaining the current pricing level for private brand products (original products planned, developed, manufactured and sold by retailers such as supermarkets and other distributors and specialist shops) whilst creating higher priced new products with added value, and has been seen in apparel and other retailers.

These developments may lead to a change in the pricing behavior of companies and consumer price perceptions towards comfort and added value, facilitating a shift away from the low-priced deflationary thinking dominant since the early 1990's.

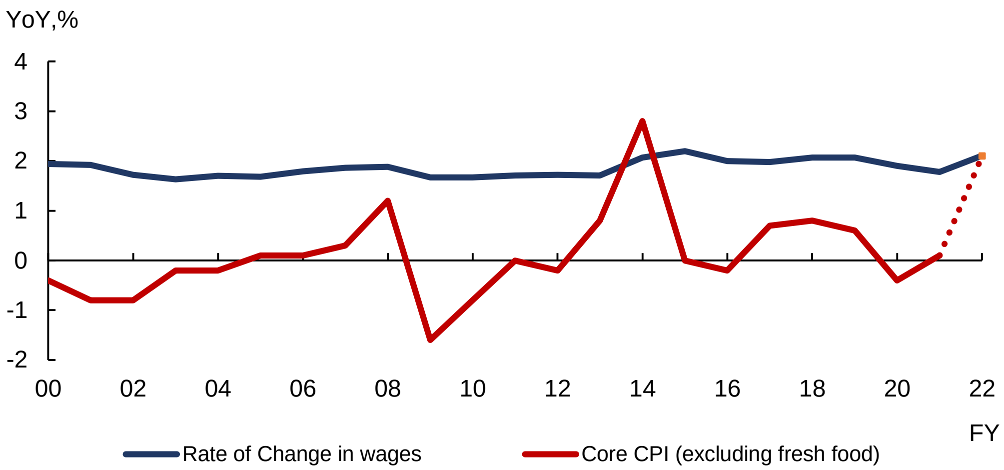
Going forward the sustainability of price increases will be in focus. We believe that the key to maintaining a virtuous cycle is sustainable wage increases. In Japan, annual wage negotiations between enterprise unions and employers called *Shunto* take place annually in the Spring. At the 2022 *Shunto* wages increase +2.1% (as of 12 April, including regular pay rises), marking the first time since 2019 that the rate has exceeded 2%, but is yet to match the level of +2.2% achieved in 2015 as it came amid strong lingering uncertainty over the direction of the pandemic, the situation in Ukraine, and other factors (Figure 3). Given that the aim of *Shunto* negotiations is to maintain workers' livelihoods, inflation trends, which affect real purchasing power, are one of the important factors in negotiations. Although there have been no major changes in 'price trends' so far (Figure 4), with the CPI expected to remain above +2% this year, attention will be focused on whether wage increases at the 2023 *Shunto* will take full account of price rises.

"Wage increases are key to the sustainability of price increases"

Wages are also affected by labour shortages and policies: In Japan, three years from now in 2025, the baby-boomer generation will have transitioned into the latter stage elderly demographic (defined as people aged 75 and over), and the labour shortage is expected to worsen significantly. For companies, market competitive wage policies to secure the workforce will be a key issue in addition to investments in efficiency.

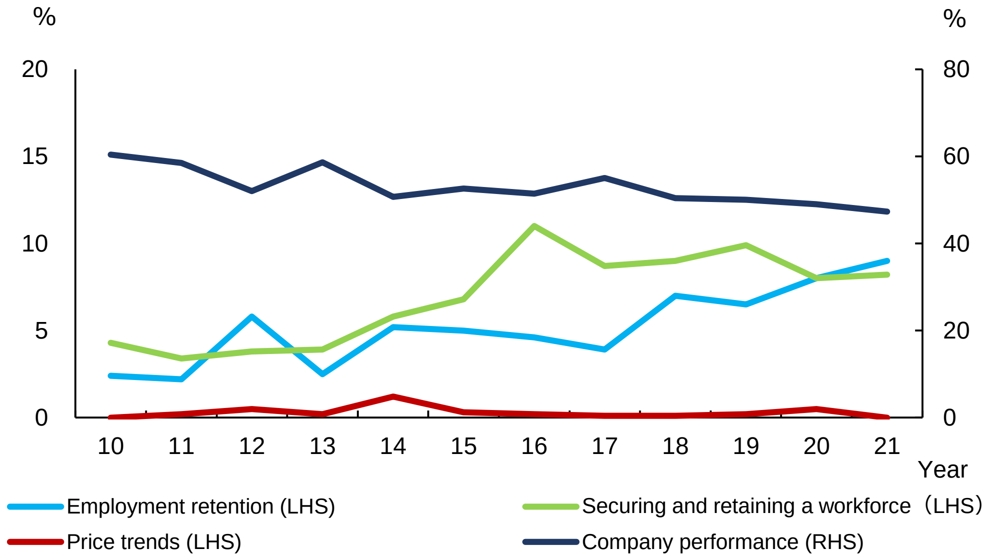
In his policy speech in January 2022, Prime Minister Kishida stated in his "distribution strategy to achieve a sustainable economy with a virtuous circle of growth and distribution" that he would expand the wage tax incentive system, raise public prices, and increase the number of workers in the labour market. In addition, he referred to the creation of an environment in which small and medium-sized enterprises, which are suffering from the rising cost of raw materials, are able to pass on the higher prices to their customers.

Figure 3: Rate of Change in wages at *Shunto* and Core CPI



Source: JTUC, Ministry of Internal Affairs and Communications
Period: Annual data from FY2000 to FY2022
Note: Rate of change in wages is the final aggregated value as of the end of June of each year.
FY2022 as of April 12.
Core CPI of FY2022 is based on AMOne projections.

Figure 4: The most emphasized factor in determining wage revision



Source: Ministry of Health, Labour and Welfare
Period: Annual data from 2010 to 2021
Note:Chart displays an extract of four of nine factors

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