QNB Economics
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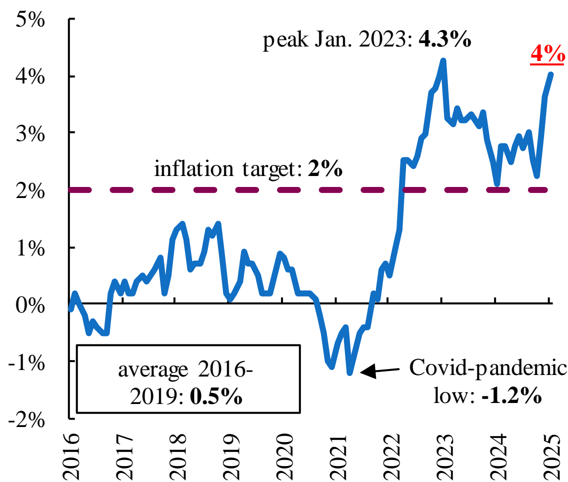
Has Japan escaped from its long-standing "deflationary trap"?

The aftermath of the Covid-pandemic brought inflation across advanced economies to skyrocketing heights not seen in decades. Following the pandemic and the Russia-Ukraine War, the "supply shock" of confinement measures and geopolitical disruptions were coupled with the "demand shock" from unprecedented policy stimulus, driving inflation rates to multi-decade highs. Initially, Japan seemed to be an exception in the inflationary environment. However, after major central banks began to hike interest rates to placate inflation and the interest rate gap with Japan widened, the Japanese Yen (JPY) depreciated sharply, prompting a wave of price pressures in Japan as well.

The sharp currency depreciation added to global price pressures, pushing Japanese consumer inflation to a peak of 4.3% year-over-year in January 2023, a level that had not been reached in this country in over three decades. The increase in inflation allowed the BoJ to finally end negative rates for the first time in 17 years, and to raise rates rates twice since then, although still at a low 0.5%.

Consumer Price Inflation in Japan
(%, year-over-year)



Source: Bank of Japan, Haver Analytics, QNB Economics

During 2023-2024 consumer price growth moderated, even if still uncomfortably above target, as the international prices of energy and commodities receded, and the government provided households with temporary relief through subsidies. But price pressures re-emerged sharply, and inflation surged to 3.7% in December last year and then to 4% in January this year, fuelled by higher domestic food prices, the phasing out of government energy subsidies, and a rise in rents.

Spiralling prices put the Japanese economy in an highly unusual scenario. For decades, before the pandemic, Japan had struggled with a negative cycle of deflation and stagnant economic activity. During 2013-2020, a time that came to be known as "Abenomics" after then prime minister Shinzo Abe, Japan implemented aggressive fiscal and monetary stimulus to boost the economy. But these policies had little success in bringing the country out of the negative cycle, as "deflationary behaviour" was entrenched in the private sector.

In our view, however, there is a significant chance that the current inflation environment could end the country's long-standing deflationary trap. Indeed, we believe that inflation in Japan will persist for longer, allowing the BoJ to continue its gradual process of interest rate normalization. In this article, we discuss the three key factors that support our view.

First, inflation data point to the persistence in increases in prices and a shift in inflation expectations. Inflation has remained significantly above the 2% target of monetary policy for almost three years. Furthermore, in a country where price stability has historically been the norm, the upsurge in inflation is altering expectations, which are now shifting decisively for firms and households. Surveys show that Japanese firms expect inflation rates of 2.3% over the next three years, markedly above the target of monetary policy. Renewed price pressures and de-anchored inflation expectations point to sustained inflation in the medium term.

Second, increasing salaries are leading to an improvement in the purchasing power of households, which is set to provide a boost to consumption and inflation. In mid-2024, growth in wages adjusted for prices began to recover, on the back of the "Shunto agreement" – the yearly negotiations between labor unions and corporate leaders – that led to average wage increases of 5.1% that year, the largest in 33 years. This year, the negotiations are set to reach an agreement that would deliver wage increases of close to 5.3%. This implies an additional improvement in

the purchasing power of households, and support for consumption, along with additional pressure on prices. Furthermore, wage increases are taking place in a context of labor shortages, which results in a stronger pass-through from increased labor costs to higher prices set by firms.

Third, the government has put forth a fiscal program that aims to provide further stimulus to the economy, resulting in additional pressure on prices. The fiscal plan includes a record budget with the equivalent of USD 735 Bn for the fiscal year 2025, and a supplementary stimulus package of around USD 90 Bn. The measures included in the program will support households through direct financial provisions to low income families, subsidies to alleviate the impact of utility and energy costs, as well as raising the annual tax-free salary threshold to encourage workforce participation. These expansionary fiscal measures will contribute to inflationary pressures.

All in all, inflation is set to remain above the 2% target of monetary policy until early 2026, on the back of persistent price pressures and shifting inflation expectations, increasing wages, and a stimulative government fiscal program. This will allow the BoJ to continue its gradual process of interest rate normalization, with at least one additional 25 basis points policy rate hike this year.

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