Getting serious about wage inflation in Japan

Japan needs inflation, and more than the 0.5% the Bank of Japan has achieved with its quantitative easing program.

In contrast to other parts of the world, the need is not primarily for cyclical reasons, even if the economy is only narrowly dodging recession. Unemployment is roughly at the natural rate, and Japanese gross domestic product growth, as dismal as it is, is averaging only a little below potential growth -- in fact, measured on a per capita basis, it has exceeded that of most other advanced economies since well before the financial crisis. If this state of the real economy can be achieved and sustained, despite being near deflation, it will be enough for stabilization policy.

But Japan needs meaningfully positive inflation for fiscal stability. Public debt, even on a net basis, is very high at 140% of GDP, high enough that it would not take much of an adverse shock (or maybe no adverse shock at all) to induce unsustainable debt dynamics -- such as interest payments spiraling up to consume much of the government budget. Bets against Japanese government bonds have been losers to date, due to a combination of financial repression, home bias by Japanese investors, and the ability to issue debt in a currency the BOJ can print. That combination cannot win out forever. Given demographics, the trajectory for public health and pension expenditures is rising, and household savings are falling; Japan's net foreign asset position is declining from a large surplus, and with annual 1-2% current-account deficits, it will likely go negative within 15 years.

Inflation to the rescue

Why would inflation help with this fiscal dilemma? There is a reason economists speak of inflation as a form of taxation, and in certain circumstances like Japan today, positive inflation can play a constructive part in a fiscal stabilization effort. Together with low nominal rates provided by the BOJ, it would lead to negative real rates and allow for a decrease in debt, eventually to more sustainable levels. No debt reduction goes without some pain, and debt holders would suffer from the direct costs of inflation, but our proposal would give the average Japanese taxpayer and debtor some recompense for the cumulative 15-20% of GDP that deflation transferred to bond holders over the last 20 years.

More importantly for the country as a whole, ongoing positive inflation would allow for a gentle, coordinated reduction in public debt and thereby ease many other needed reforms. Note that we are not advocating expropriation through hyperinflation. What we have in mind, as we develop below, is high single-digit inflation initially, followed by somewhat lower inflation later. We do not believe it is likely to cause upward-spiraling inflation. If it did, Japan should be so lucky, and the BOJ could easily stop such a spiral.

Getting inflation up in Japan -- and now elsewhere in the advanced economies -- has proven more difficult than expected. The Abenomics program and the BOJ's commitment to a 2% inflation target were premised on the idea that together they could induce a virtuous cycle from positive inflation to wage increases to greater consumption and so on, while pursuing structural reforms. The cycle was presumed to start with expansionary monetary policy, committed to by BOJ Gov. Haruhiko Kuroda starting in April 2013, as well as a broad depreciation of the yen (caused by expectations of change in monetary regime) from its overvalued level of 79 to the dollar.

In particular, it was hoped that QE would do the trick in starting the process, by lifting inflation expectations and changing price- and wage-setting behavior in Japan as a result. Large-scale asset purchases of JGBs by the BOJ, at the rate of 80 trillion yen a month, committed to continue until inflation remains above an announced 2% target, have had some impact -- but it is insufficient. Since the QE policy has been undertaken in earnest, the yen has declined in two stages to 120-plus to the dollar, and inflation in Japan has fluctuated between 0.5% and 1.0%. This is an improvement, compared to the minus 0.5% to minus 1.0% deflation experienced during the preceding decade-plus of monetary inaction.

It has proven insufficient to lead to ongoing domestic inflation, however, especially in the face of falling energy prices, and now the Chinese slowdown. Critically, nominal wages, intended to be the next step in the virtuous cycle, rose only a little more than 1% in 2014 and 2015. For the average Japanese investor and consumer, not seeing is not believing, and inflation expectations have not budged much on any measure (surveys, bond prices, or professional forecasts).

Jump-start needed

Given the insufficient transmission of monetary expansion, for whatever reason, more direct measures are required to get inflation up in Japan. What is needed is a jump-start to a wage-price spiral of the sort feared from the 1970s, but precisely what the Abenomics proposal rightly made the center of its response to more than 15 years of deflation. We believe that such a process is best triggered by an increase of nominal wages and other benefits by 5% to 10% by fiat in the next year.

Though relatively unheard-of in the U.S., tripartite bargaining like that in Europe actually is widely practiced in Japan, meaning that annually there are wage negotiations in February and March for the unionized permanent part of the Japanese labor force, and government observers participate in the process. About one-third of Japanese workers are directly covered by these bargains, and many more (including management employees) have their wage adjustments set based on the result of these negotiations; others, including part-time workers, do have a positive correlation between these wage settlements and their pay as well.

Such bargaining with government input can be used to push up wages up as it was in the past was to control wage inflation. In the 2014 and 2015 wage rounds, the Abe administration has not been shy about publicly stating its desire to see wages rise, but in practice has not tried to force the issue. In fact, this and preceding administrations have made matters worse by cutting public-sector workers' pay, which has negative spillovers on private sector wages. A few major employers, including Toyota Motor and Lawson, have tried to set a leadership example by raising wages.

Yet, in a period when corporate Japan has gained record profits, in part through yen depreciation, even most export-oriented manufacturers in Japan have failed to share the gains through meaningful wage increases. The recent announcement by the Abe government to raise the minimum wage was the right first step, but was insufficient in terms of scope of workers covered and size of raise required.

It is time for Japan to get serious about raising wages. A stronger set of inducements to get wages up should be employed by the Japanese government ahead of the 2016 wage round, including:

- Hold off on bringing the promised permanent cut in Japanese corporate taxes to the Diet until Japanese corporations overall deliver on raising wages
- Increase public-sector nominal wages to put upward pressure on labor markets as competition for better workers
- Adjust upward minimum wages and other administratively set wages in government contracts and regulated sectors by at least 5%
- Institute wage-indexation for workers for whom the government has executive order capacity, and bring to the Diet a bill requiring indexation more broadly (say at 3% or the rate of core-core CPI annually, whichever is higher)

The result will be an initial burst of inflation, which will most likely de-anchor expectations upward, and in so doing, lead to higher inflation for some time. The point is not to redistribute from business to labor. If anything, to have the desired effect, employers and other price-setters should be encouraged to pass on their increased costs from wages to consumer prices, and to maintain their margins. Meanwhile, the BOJ should indicate that monetary policy will accommodate this general price and wage increase by maintaining QE and other unconventional monetary policies at least until the cycle takes hold over a three year period. The BOJ should also allow for a fall in the exchange rate of the Yen as inflation increases, so as to maintain a stable real exchange rate in the face of higher inflation.

This means replacing the current 2% inflation target with something much higher, which ironically may be easier to achieve once undertaken. Obviously, the higher the rate of inflation, the faster the government debt reduction in real terms, but also the higher the costs from inflation to the rest of the economy. To the extent that the adjustment of prices to wages is likely to be uneven, it will lead to undesirable allocation distortions and redistribution effects. We suggest that aiming for a high single-digit inflation rate next year, slowly decreasing over time, is probably the right target for Japan. Just for context, a 10% increase in the price level implies a decrease in the net debt to GDP ratio of 16%. If Japanese output is indeed close to potential at present, this program will lead to more inflation pressure, which, under the circumstances, would be highly desirable.

Interest issues

An objection we expect is that the increase in inflation will be met by an increase in nominal interest rates, or that the Fisher effect will prevail sooner or later. The crucial part of the statement, however, is "sooner or later." There is absolutely no reason why the BOJ cannot keep nominal interest rates low while inflation increases for a few years. The last two decades demonstrate that forward-looking fears about debt sustainability have limited impact on Japanese bond market conditions -- when that starts to kick in, that will mean that inflation expectations will have risen. When inflation is high enough, or begins to increase beyond the desirable level, the BOJ can then increase nominal rates.

It should be clear from the past that inflation is not a painless miracle cure.

There is a reason the reduction of the real value of money or debt through inflation is called the inflation tax. And those who pay the inflation tax will not only suffer but also decrease spending. The decrease in aggregate demand for a given debt reduction through inflation is likely, however, to be two orders of magnitude smaller in the short run than under the more standard alternatives. Based on what we know about the marginal propensity to consume out of wealth in Japan, a decrease in debt of 10% of GDP will lead to a decrease in spending of about 0.5% by bondholders. To decrease the primary deficit by the same 10% of GDP through spending cuts, the government would need a more than 11% of GDP reduction in spending, assuming a multiplier of at least 1 decreasing tax revenues. This is about making the best of bad choices before the choice is made for Japan by a fiscal event that would necessitate very sharp social spending cutbacks and tax increases. Such abrupt consolidation would like make fiscal balancing worse by slowing growth rapidly.

After nearly two decades of deflation and accumulating government deficits, Japan needs strongly positive inflation as part of its fiscal stabilization package. The measures undertaken to raise inflation so far have proven insufficient to induce a virtuous cycle from inflation to wages to consumption to further inflation. Starting higher inflation through a general increase in wages, as radical as it sounds, may be the most responsible measure that the government of Japan can pursue for the nation's fiscal health, and one the BOJ should support.

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